Transfer for Value Rule (II.Q.4.), Income Tax Consequences of Trust Modifications (II.J.18. and III.B.1.), and Code §199A Safe Harbor for Real Estate (II.E.1.e.)

(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," over 2,300 pages in a fully searchable PDF 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

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 This is not intended to be comprehensive; many portions only lightly touch the surface; and not all of the issues are updated at the same time (in fact, the author does not systematically refresh citations), so some parts may be less current than others. The author invites suggested changes, whether substantive or to point out typos (the author does not have a second set of eyes reviewing the author's work). The views expressed herein reflect the author's preliminary thoughts when initially written and are not necessarily those of Thompson Coburn LLP (or even of the author). Before using any information contained in these materials, a taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. Tax advisors should research these issues independently rather than rely on these materials.

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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.

II.E.1.e. Whether Real Estate Qualifies As a Trade or Business

Part II.E.1.e.i General Rules Regarding U.S. Real Estate describes the definitions of a trade or business generally applied to real estate.

For nonresident aliens, Part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules explains when real estate may be eligible for a Code § 199A deduction.

Before analyzing the rules for whether real estate qualifies as a business, consider whether one really wants to do so. Real estate tends to generate ordinary losses, which may reduce the Code § 199A deduction from other businesses.[889] Much of the profit tends to be capital gain on sale, which is not eligible for the deduction.[890] A partner in the national office of a Big Four CPA firm told me that the percentage of real estate investors who benefitted materially from Code § 199A with respect to their real estate was in the single digits, and the burdens of recordkeeping for UBIA[891] were often more costly than the benefits.

II.E.1.e.i. General Rules Regarding U.S. Real Estate under Code § 199A

To constitute qualified business income, the income must be from a trade or business.[892] However:

- Rental activity that is not a trade or business can qualify as if it were a trade or business if it is rented or licensed to a trade or business which is commonly controlled under Reg. § 1.199A-4(b)(1)(i), meaning that the same person or group of persons, directly or by attribution under Code §§ 267(b) or 707(b),[893] owns 50% percent or more of the renting trade or business, including 50% or more of the issued and outstanding shares of an S corporation or 50% or more of the capital or profits in a partnership.[894] This is described in

[889] See part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.
[890] See part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[891] See part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A, which is within part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[892] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.
[893] For Code §§ 267(b), see part II.G.4.l.iv Code § 267 Disallowance of Related-Party Deductions or Losses. For Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships
[894] Reg. § 1.199A-4(b)(1)(i) is reproduced in full in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A and illustrated by various Examples accompanying fn 786, including those demonstrating that a pass-through entity that owns a business can be in a different type of pass-through entity (S corporation compared to partnership) than the type that owns the real estate.

part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A [895] and illustrated in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A, [896] but it applies whether or not the real estate is aggregated (see fn 895).

- On the other hand, if rental is tied too closely to a specified service trade or business (SSTB), part or all of the rental income could be disqualified, even the rental on its own qualifies as a trade or business. See part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules.

As to the first bullet point, the preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.3.c, "Special Rule for Renting Property to a Related Person Real Estate Activities as a Trade or Business," explains:

> In one instance, the proposed regulations and the final regulations extend the definition of trade or business for purposes of section 199A beyond section 162. Solely for purposes of section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing activity and the other trade or business are commonly controlled under proposed § 1.199A-4(b)(1)(i). This rule also allows taxpayers to aggregate their trades or businesses with the leasing or licensing of the associated rental or intangible property if all of the requirements of proposed § 1.199A-4 are met.
>
> One commenter asked for clarification regarding whether this rule applies to situations in which the rental or licensing is to a commonly controlled C corporation. Another commenter suggested that the rule in the proposed regulations could allow passive leasing and licensing-type activities to benefit from section 199A even if the counterparty is not an individual or an RPE. The commenter recommended that the exception be limited to scenarios in which the related party is an individual or an RPE and that the term related party be defined with reference to existing attribution rules under sections 267, 707, or 414. The final regulations clarify these rules by adopting these recommendations and limiting this special rule to situations in which the related party is an individual or an RPE. Further, as discussed in part V.B. of this Summary of Comments and Explanation of Revisions, the final regulations provide that the related party rules under sections 267(b) or 707(b) will be used to determine relatedness for purposes of § 1.199A-4 and this special rule.

The preamble to the final regulations also considers whether the taxpayer treats the activity as a trade or business for other tax purposes.[897]

Each RPE separately determines whether its real estate qualifies as a trade or business. Real estate owners might want to combine their RPEs into a master partnership in which each LLC is a disregarded entity. See the discussion at the end of the introductory portion of part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.[898]

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[895] See Reg. § 1.199A-1(b)(14), which is reproduced in full in fn 759 in that part.

[896] Within that part, see text accompanying fn 790, analyzing Reg. § 1.199A-4(d)(8), Example (8) and Reg. § 1.199A-4(d)(9), Example (9).

[897] See text preceding fn 758 in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.

[898] See text accompanying fn 715.

The rest of the discussion in this part II.E.1.e.i discusses:

- Whether real estate activity constitutes a trade or business under Code § 162. See part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business.
- Whether separate real estate businesses can combine their QBI, W-2 wages, and UBIA. See part II.E.1.e.i.(b) Aggregating Real Estate Businesses.

II.E.1.e.i.(a). Whether Real Estate Activity Constitutes A Trade Or Business

Whether real estate is a trade or business depends on the circumstances. The best discussion of the issue in this document is in part II.I.8.c.iii Rental as a Trade or Business, fns 2202-2213. Another discussion on what is a trade or business is in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162. See also part II.G.27.b Real Estate as a Trade or Business.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.3.b, "Rental Real Estate Activities as a Trade or Business," explains:

> A majority of the comments received on the meaning of a trade or business focus on the treatment of rental real estate activities. Commenters noted inconsistency in the case law in determining whether a taxpayer renting real estate is engaged in a trade or business. Some commenters suggested including safe harbors, tests, or a variety of factors, which if satisfied, would qualify a rental real estate activity as a trade or business. A number of commenters suggested that all rental real estate activity should qualify as a trade or business. Further, one commenter suggested that rental income from real property held for the production of rents within the meaning of section 62(a)(4) should be considered a trade or business for purposes of section 199A. Another commenter suggested that final regulations provide that an individual whose taxable income does not exceed the threshold amount will be considered to be conducting a trade or business with respect to any real estate rental of which the individual owns at least ten percent and in which the individual actively participates within the meaning of section 469(i).
>
> In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).
>
> Providing bright line rules on whether a rental real estate activity is a section 162 trade or business for purposes of section 199A is beyond the scope of these regulations. Additionally, the Treasury Department and the IRS decline to adopt a position deeming all rental real estate activity to be a trade or business for purposes of section 199A. However, the Treasury Department and IRS recognize the difficulties taxpayers and practitioners may have in determining whether a taxpayer's rental real estate activity is sufficiently regular, continuous, and considerable for the activity to constitute a section 162 trade or business. Accordingly, Notice 2019- 07, 2019-9 IRB, released concurrently with these final regulations, provides notice of a proposed revenue

> procedure detailing a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A.
>
> Under the proposed safe harbor, a rental real estate enterprise may be treated as a trade or business for purposes of section 199A if at least 250 hours of services are performed each taxable year with respect to the enterprise. This includes services performed by owners, employees, and independent contractors and time spent on maintenance, repairs, collection of rent, payment of expenses, provision of services to tenants, and efforts to rent the property. Hours spent by any person with respect to the owner's capacity as an investor, such as arranging financing, procuring property, reviewing financial statements or reports on operations, planning, managing, or constructing long-term capital improvements, and traveling to and from the real estate are not considered to be hours of service with respect to the enterprise. The proposed safe harbor also would require that separate books and records and separate bank accounts be maintained for the rental real estate enterprise. Property leased under a triple net lease or used by the taxpayer (including an owner or beneficiary of an RPE) as a residence for any part of the year under section 280A would not be eligible under the proposed safe harbor. A rental real estate enterprise that satisfies the proposed safe harbor may be treated as a trade or business solely for purposes of section 199A and such satisfaction does not necessarily determine whether the rental real estate activity is a section 162 trade or business. Likewise, failure to meet the proposed safe harbor would not necessarily preclude rental real estate activities from being a section 162 trade or business.
>
> Examples 1 and 2 of proposed § 1.199A-1(d)(4) describe a taxpayer who owns several parcels of land that the taxpayer manages and leases to airports for parking lots. The Treasury Department and the IRS are aware that some practitioners and taxpayers questioned whether the use of the lease of unimproved land in these examples was intended to imply that the lease of unimproved land is a trade or business for purposes of section 199A. Proposed § 1.199A-1(d)(4) provides that for purposes of the examples all businesses described in the examples are trades or business for purposes of section 199A. Example 1 was intended to provide a simple illustration of how the calculation would work if a taxpayer lacked sufficient W-2 wages or UBIA of qualified property to claim the deduction. Example 2 built on the fact pattern by adding UBIA of qualified property to the facts. The examples in the proposed regulations were not intended to imply that the lease of the land is, or is not, a trade or business for purposes of section 199A beyond the assumption in the examples. In order to avoid any confusion, the final regulations remove the references to land in both examples.

Rev. Proc. 2019-38 "provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business" solely for purposes of Code § 199A and the regulations thereunder.[899] "If an enterprise fails to satisfy the requirements of this safe harbor, it may be treated as a trade or business for purposes of section 199A if the enterprise otherwise meets the definition of trade or business in § 1.199A-1(b)(14)."[900]

[899] Rev. Proc. 2019-38, § 1.

[900] Rev. Proc. 2019-38, § 1. Rev. Proc. 2019-38, § 3.01 reiterates this:

Below we will describe the safe harbor and then discuss actions to take if not within the safe harbor.

Rev. Proc. 2019-38, § 3.01 describes who may use the safe harbor:

> This safe harbor is available to taxpayers who seek to claim the deduction under section 199A with respect to a rental real estate enterprise as defined in section 3.02. If the safe harbor requirements are met, the rental real estate enterprise will be treated as a single trade or business as defined in section 199A(d) for purposes of applying the regulations under section 199A, including the application of the aggregation rules in § 1.199A-4. RPEs, as defined in § 1.199A-1(b)(10),[901] may also use this safe harbor. In order to rely upon the safe harbor, taxpayers and RPEs must satisfy all of the requirements of this revenue procedure.

Rev Proc. 2019-38, § 3.02, "Rental real estate enterprise," provides:

> Solely for purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties. The taxpayer or RPE relying on this revenue procedure must hold each interest directly or through an entity disregarded as an entity separate from its owner under any provision of the Code.
>
> Except for those property interests described in paragraph .05 of this section, taxpayers and RPEs may either treat each interest in similar property held for the production of rents as a separate rental real estate enterprise or treat interests in all similar properties held for the production of rents as a single rental real estate enterprise. For purposes of applying this revenue procedure, properties held for the production of rents are similar if they are part of the same rental real estate category. The two types of rental real estate categories for the purpose of combining properties into a single rental real estate enterprise are residential and commercial. Thus, commercial real estate held for the production of rents may only be part of the same enterprise with other commercial real estate, and residential properties may only be part of the same enterprise with other residential properties.
>
> Once a taxpayer or RPE treats interests in similar commercial properties or similar residential properties as a single rental real estate enterprise under the safe harbor, the taxpayer or RPE must continue to treat interests in all similar properties, including newly acquired properties, as a single rental real estate enterprise when the taxpayer or RPE continues to rely on the safe harbor. However, a taxpayer or RPE that chooses to treat its interest in each residential or commercial property as a separate rental real estate enterprise may choose to treat its interests in all similar commercial or all similar residential properties as a single rental real estate enterprise in a future year.
>
> An interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. For purposes of

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> Failure to satisfy the requirements of this safe harbor does not preclude a taxpayer or the Service from otherwise establishing that an interest in rental real estate is a trade or business for purposes of section 199A.

[901] [My footnote:] Reg. § 1.199A-1(b)(10) is reproduced in the text accompanying fn 711 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

> this revenue procedure, mixed-use property is defined as a single building that combines residential and commercial units. An interest in mixed-use property, if treated as a single rental real estate enterprise, may not be treated as part of the same enterprise as other residential, commercial, or mixed-use property.
>
> Each rental real estate enterprise that satisfies the requirements of this safe harbor is treated as a separate trade or business for purposes of applying section 199A and the regulations thereunder.

The first two paragraphs of § 3.02 closely follow Notice 2019-7, and the rest is elaboration. Providing that commercial and residential real estate may not be part of the same enterprise is consistent with Reg. § 1.199A-4(d)(17), Example (17), which is reproduced in part II.E.1.e.i.(b) Aggregating Real Estate Businesses (the latter also including other commentary about delineating between separate real estate businesses).

Rev Proc. 2019-38, § 3.03, "Safe harbor," provides:

> The determination to use this safe harbor must be made annually. Solely for the purposes of section 199A, each rental real estate enterprise will be treated as a single trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:
>
> (A) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise. If a rental real estate enterprise contains more than one property, this requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated;
>
> (B) For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise. For rental real estate enterprises that have been in existence for at least four years, in any three of the five consecutive taxable years that end with the taxable year, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise; and
>
> (C) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. If services with respect to the rental real estate enterprise are performed by employees or independent contractors, the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor. Such records are to be made available for inspection at the request of the IRS.

The second sentence of each of (A) and (C) above were not in Notice 2019-7.

Although the IRS steadfastly rejects using the passive loss rules for Code § 199A, cases under those rules may give a clue to how courts approach documenting work. See part II.K.1.a.vi Proving Participation. I view the regulations under the passive loss rules as a little less strict than the rules provided above, so please read part II.K.1.a.vi keeping that in mind.

Rev Proc. 2019-38, § 3.03(D) provides more details about what the taxpayer must attach:

> The taxpayer or RPE attaches a statement to a timely filed original return (or an amended return for the 2018 taxable year only) for each taxable year in which the taxpayer or RPE relies on the safe harbor. An individual or RPE with more than one rental real estate enterprise relying on this safe harbor may submit a single statement but the statement must list the required information separately for each rental real estate enterprise. The statement must include the following information:
>
> (1) A description (including the address and rental category) of all rental real estate properties that are included in each rental real estate enterprise;
>
> (2) A description (including the address and rental category) of rental real estate properties acquired and disposed of during the taxable year; and
>
> (3) A representation that the requirements of this revenue procedure have been satisfied.

That requirement lessens the burden of Notice 2019-7, which required a statement signed under penalties of perjury.

Rev Proc. 2019-38, § 3.04, "Rental services," provides:

> Rental services for purpose of this revenue procedure include, but are not limited to: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property, including the purchase of materials and supplies; (vi) management of the real estate; and (vii) supervision of employees and independent contractors. Rental services may be performed by owners, including owners of an RPE, or by employees, agents, and/or independent contractors of the owners. The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; improving property under § 1.263(a)-3(d); or hours spent traveling to and from the real estate.

The above is essentially the same as what was in Notice 2019-7.

Rev Proc. 2019-38, § 3.05, "Certain rental real estate arrangements excluded," provides:

> The following types of property may not be included in a rental real estate enterprise and are therefore not eligible for the safe harbor:
>
> (A) Real estate used by the taxpayer (including an owner or beneficiary of an RPE) as a residence under section 280A(d).
>
> (B) Real estate rented or leased under a triple net lease. For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or

lessee to pay taxes, fees, and insurance, and to pay for maintenance activities for a property in addition to rent and utilities.

(C) Real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled under § 1.199A-4(b)(1)(i).

(D) The entire rental real estate interest if any portion of the interest is treated as an SSTB under § 1.199A-5(c)(2) (which provides special rules where property or services are provided to an SSTB).

Subparagraph (B) is narrower than Notice 2019-7, which provided:

> For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities. This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

"To be responsible for maintenance activities" indicated to me that, for the lease be a disfavored "triple net lease" under Notice 2019-7, the tenant had to not only pay for maintenance but also arrange the maintenance. Rev Proc. 2019-38 eliminates the responsibility requirement by providing that mere payment of maintenance is enough connection to maintenance activity that, when combined with other factors in both tests, would make the lease a triple net lease. My understanding is that this change will knock most large shopping centers and large office buildings out of the safe harbor; however, those activities do not appear to need a safe harbor anyway, given the level of service typically provided. I am more concerned about real estate with only one or a very few tenants, where the IRS seems to want the landlord to take more risk

Subparagraph (d) is new, greatly expanding the scope of the anti-abuse rules described in part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules. For example, suppose a real estate developer owned a building through an LLC and used separate S corporations to run its development business, its engineering affiliate, its architectural affiliate, and its furniture leasing affiliate. Because these are different types of businesses,[902] they would be segregated under the anti-abuse rules, and only real estate rental payments received from the furniture leasing affiliate would constitute income from an SSTB.[903]

In addition to making sure that one provides enough qualifying services, beware of the possible cost of providing services beyond what a landlord provides in a traditional long-term lease. Although traditional services should be exempt from self-employment (SE) tax, services beyond that may be subject to SE tax. See part II.L.2.a.ii Rental Exception to SE Tax, especially the text accompanying fns 3145-3148.

[902] They would constitute separate businesses even if in the same RPE - see part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items.

[903] Reg. § 1.199A-5(c)(iii)(B), Example (2) segregates SSTBs from non-SSTB's so that the former do not contaminate the latter even when the former is not de minimis. Furthermore, Reg. § 1.199A-5(c)(2) disqualifies self-rental to an SSTB only to the extent of payments the landlord receives from the SSTB.

Rev Proc. 2019-38, § 4, "Effective Date," provides:

> This revenue procedure applies to taxable years ending after December 31, 2017. Alternatively, taxpayers and RPEs may rely on the safe harbor set forth in Notice 2019-07, 2019-09 IRB 740, for the 2018 taxable year. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2020. However, taxpayers are reminded that they bear the burden of showing the right to any claimed deductions in all taxable years. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84; 112 S.Ct. 1039, 1043) (1992); *Interstate Transit Lines v. Comm'r*, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281 (1943). See also I.R.C. § 6001; Treas. Reg. § 1.6001-1(a) and (e).

Prop. Rev Proc. § 3.05 provides that triple net leases do not qualify for the safe harbor. (It assumes that a tenant does all of the work in a triple net lease, but it is also common for a landlord to actively maintain the property on a substantial and continuous basis that would qualify as a business, while still requiring tenants to reimburse the landlord for all annual operating costs, which is also a triple net lease.) Instead of the tenant arranging for and paying for maintenance, have the landlord take care of that and obtain reimbursement from the tenant. Consider having the landlord hire the janitors and maintenance staff and the tenant reimburse the landlord for those expenses, which helps not only move the real estate toward being a trade or business but also may improve the landlord's Code § 199A deduction:

- The tenant may have plenty of wages for purposes of the wage limitation for the Code § 199A deduction, whereas paying those wages may provide the landlord with a higher Code § 199A deduction (because the wage limitation will not reduce the deduction as much).[904] However, if the real estate activity is aggregated with a business under common control,[905] that business' wages and property count toward the Code § 199A deduction relating to the real estate's income.

- If the landlord and tenant have similar ownership, then moving duties from one entity to another may be an easy decision. On the other hand, if they have different owners and the landlord does not want an increased role, these changes may be impractical.

- Consider asset protection issues. If the landlord hires janitors and maintenance staff, the landlord would be liable if they fail to remedy any hazardous conditions. Furthermore, if an owner of the landlord is personally involved in hiring decisions, that owner may be personally liable for negligent hiring. Liability insurance may ameliorate these concerns, and every landlord should have such insurance anyway to try to avoid corporate veil piercing. This is very much a judgment call. For more on asset protection, see part II.F Asset Protection Planning.

Even the long-term rental of one property to one tenant can constitute a trade or business.[906] For further thoughts on how to make real estate a trade or business, see my summary at the end of part II.I.8.c.iii Rental as a Trade or Business.

Note also what is required for real estate not to be passive income for purposes of restrictions on S corporations that used to be C corporations, described in part II.P.3.b.iii Excess Passive

[904] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[905] See fns 895-894.
[906] See part II.I.8.c.iii Rental as a Trade or Business, fn 2209.

Investment Income. A triple net lease in which the landlord did nothing except collect rents would not work for that test, but incurring expenses and having them reimbursed by the tenant may work.[907] Following these rules for S corporations does not directly address the "trade or business" issue, but if the IRS views it as nonpassive for one purpose (the S corporation test) then an examiner might have a positive view for other purposes (trade or business qualification).

Ultimately, one needs to decide whether the effort of and exposure from rearranging lease arrangements are worth the potential tax benefits, and it is impossible to provide a one-size-fits-all solution.

II.E.1.e.i.(b). Aggregating Real Estate Businesses

This part II.E.1.e.i.(b) applies to real estate the rules of part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A. For the assumptions to Example (16), Example (17), and Example (18), see the introduction to Reg. § 1.199A-4(d), reproduced in part II.E.1.c.iii.(d).[908]

Reg. § 1.199A-4(d)(16), Example (16) provides:

> (i) *Facts*. PRS1, a partnership, owns 60% of a commercial rental office building in state A, and 80% of a commercial rental office building in state B. Both commercial rental office building operations share centralized accounting, legal, and human resource functions. PRS1 treats the two commercial rental office buildings as an aggregated trade or business under paragraph (b)(1) of this section.
>
> (ii) *Analysis*. PRS1 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, PRS1 may aggregate its commercial rental office buildings because the businesses provide the same type of property and share accounting, legal, and human resource functions.

Example (16) helpfully demonstrates that real estate activities in different states can be aggregated.

Reg. § 1.199A-4(d)(17), Example (17) provides:

> (i) *Facts*. S, an S corporation owns 100% of the interests in a residential condominium building and 100% of the interests in a commercial rental office building. Both building operations share centralized accounting, legal, and human resource functions.
>
> (ii) *Analysis*. S owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Although both businesses share significant centralized business elements, S cannot show that another factor under paragraph (b)(1)(v) of this section is present because the two building operations are not of the same type of property. S must treat the residential condominium building and the commercial rental office building as separate trades or businesses for purposes of applying § 1.199A-1(d).

[907] See fns 3651-3654.
[908] See text accompanying fn 789.

Example (17) demonstrates that the IRS views residential and commercial rental as separate businesses, even if operated and managed by the same owner. Reg. § 1.199A-4(b)(1)(v) provides that trades or businesses may be aggregated only if an individual or RPE can demonstrate that -

> The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):
>
> (A) The trades or businesses provide products, property, or services that are the same or customarily offered together.
>
> (B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
>
> (C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

Thus, to aggregate, they need not only similar management (satisfying (B)) but also one other factor in (A) or (C). Reg. § 1.199A-4(d)(18), Example (18) includes another factor, providing:

> (i) *Facts*. M owns 75% of a residential apartment building. M also owns 80% of PRS2. PRS2 owns 80% of the interests in a residential condominium building and 80% of the interests in a residential apartment building. PRS2's residential condominium building and residential apartment building operations share centralized back office functions and management. M's residential apartment building and PRS2's residential condominium and apartment building operate in coordination with each other in renting apartments to tenants.
>
> (ii) *Analysis*. PRS2 may aggregate its residential condominium and residential apartment building operations. PRS2 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is satisfied because the businesses are of the same type of property and share centralized back office functions and management. M may also add its residential apartment building operations to PRS2's aggregated residential condominium and apartment building operations. M owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is also satisfied because the businesses operate in coordination with each other.

Thus, renting similar real estate (residential) is a sufficient other factor, as is operating in coordination with each other.

See also part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items. Applying 2017 tax reform to determine separate businesses is relevant not only for Code § 199A but also for Code § 512(a)(6) (preventing a tax-exempt entity from uses losses from one business against income from a separate business), which is discussed in part II.E.1.f.viii Tax-Exempt Trusts. Under that guidance, for now the IRS will consider the use of NAICS 6-digit codes to be a reasonable, good-faith interpretation under section 3.02 of this notice. The NAICS is an industry classification system for purposes of collecting, analyzing, and publishing statistical data related to the United States business economy. See Executive Office of the President, Office of Management and Budget, North American Industry Classification System (2017), available at https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf. Here are some codes for real estate:

- 531110 Lessors of Residential Buildings and Dwellings
- 531120 Lessors of Nonresidential Buildings (except Miniwarehouses)
- 531130 Lessors of Miniwarehouses and Self-Storage Units
- 531190 Lessors of Other Real Estate Property
- 531210 Offices of Real Estate Agents and Brokers
- 531311 Residential Property Managers
- 531312 Nonresidential Property Managers
- 531320 Offices of Real Estate Appraisers
- 531390 Other Activities Related to Real Estate

I am not suggesting any authority directly applying these codes for Code § 199A. However, given that guidance on how to delineate separate businesses leaves a lot of room for interpretation, using these codes may show a good-faith attempt to delineate between businesses. Furthermore, the regulations assume that residential and commercial real estate are separate businesses, and these codes tend to support that assumption.

II.E.1.e.ii. Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules

A nonresident alien may be eligible for the Code § 199A deduction only for income qualifying under Part II.E.1.c.ix QBI and Effectively Connected Income. Within that part, the text accompanying and immediately preceding fn 860 cross-references Code § 871(a)(1)(A), which taxes rents (among other income) and therefore is the subject of this part II.E.1.e.ii. Below is guidance on when rent constitutes QBI.

Rev. Rul. 73-522 discussed the following situation involving triple net leases:

> The taxpayer owned rental property situated in the United States that was subject to long-term leases each providing for a minimum monthly rental and the payment by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the property leased. The leases are referred to as "net leases" and were entered into by the taxpayer on December 1, 1971. The taxpayer visited the United States for approximately one week during November 1971 for the purpose of supervising new leasing negotiations, attending conferences, making phone calls, drafting documents, and making significant decisions with respect to the leases. This was his only visit to the United States in 1971. The leases were identical in form (net leases) to those applicable to the properties

owned by the taxpayer prior to December 1, 1971, and were entered into with lessees unrelated to each other or to the taxpayer.

Rev. Rul. 73-522 held:

> Court decisions involving nonresident alien individual owners of real estate in the United States have developed a test for determining when such individuals are engaged in trade or business within the United States as a result of such ownership. These cases hold that activity of nonresident alien individuals (or their agents) in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business within the United States, provided that such activity is considerable, continuous, and regular. *Jan Casimir Lewenhaupt*, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955); *Elizabeth Herbert*, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; *Inez De Amodio*, 34 T.C. 894 (1960), *aff'd* 229 F.2d 623 (3rd Cir. 1962).
>
> In the instant case the taxpayer's only activity in the United States during the taxable year ended December 31, 1971, was the supervision of the negotiation of leases covering rental property that he owned during that year. No other activity was necessary on the part of the lessor in connection with the properties because of the provisions of the net leases. The taxpayer's supervision of the negotiation of new leases is not considered to be beyond the scope of mere ownership of real property or the mere receipt of income from real property since such activity was sporadic rather than continuous (that is a day-to-day activity), irregular rather than regular, and minimal rather than considerable.
>
> Accordingly, the taxpayer in the instant case is not considered to be engaged in trade or business within the United States during the taxable year ended December 31, 1971, within the meaning of section 871 of the Code. See *Evelyn M. L. Neil*, 46 B.T.A. 197 (1942), wherein the operation of one parcel of real estate by the lessee did not result in the owner being considered to be engaged in trade or business.[909] Compare *Adolph*

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[909] [My footnote, not from the ruling:] *Neill v. Commissioner*, 46 B.T.A. 197 (1942), found that a net lease held by a NRA did not constitute carrying on a business. The facts were:

> … It is held under a long term lease by a tenant who, under the terms of that lease, erected a building thereon and is obligated under the lease to pay taxes and insurance and maintain the property.
>
> The property referred to is encumbered by a mortgage …, the ground lease on the property having been assigned at that time to the mortgagee as collateral security for the mortgage. For many years petitioner has employed a firm of attorneys with offices in Philadelphia, to whom the tenant pays the rentals due petitioner under her direction. These attorneys then pay for her the interest due upon the mortgage and such incidental expenses for which petitioner may be obligated.

The Board of Tax Appeals held:

> The ownership of this property by petitioner is no more a business activity carried on within the United States than her ownership of stocks or bonds of American companies held for her by an American agent. *Cf. Higgins v. Commissioner*, 312 U.S. 212. We think the rule is settled that the mere ownership of property from which income is drawn does not constitute the carrying on of business within the purview of the cited section. *McCoach v. Minehill & Schuylkill Haven Railroad Co.*, 228 U.S. 295; *Stafford Owners, Inc. v. United States*, 39 Fed.(2d) 743.

For a discussion of *Higgins*, see part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, fn 1208.

> *Schwarcz*, 24 T.C. 733, *acq.* 1956-1, C.B. 5, wherein an owner operating one parcel of rental property in all its aspects was considered to be engaging in trade or business.
>
> With regard to the second question presented, section 1.871-7(b)(1) of the Income Tax Regulations provides that for purposes of section 871(a)(1) of the Code "amounts" received (including rents) means "gross income." Section 1.61-8(c), to the extent pertinent, provides that if a lessee pays any of the expenses of the lessor such payments are additional rental income of the lessor.
>
> Accordingly, "rents," as used in section 871 of the Code, includes considerations other than the payment of a stipulated rental, *i.e.*, amounts paid by the lessee for taxes, repairs, etc., in accordance with the terms of a net lease.

Note that the taxpayer held more than one property with triple-net-leases, and the taxpayer's triple-net-lease was not part of a trade or business notwithstanding the taxpayer owning multiple properties.

Also note that expense reimbursements constituted rent.

As to rental that is not a triple-net-lease, *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), cited with approval in Rev. Rul. 73-522, stated, "We take it to be well settled that the operation of even a single parcel of rental realty may constitute the regular operation of a business."[910] Furthermore, the "fact that the taxpayer operates the rental property through an agent does not prevent him from being regularly engaged in the business,[911] and "the rule applies even though the property and the agent are in a foreign country (Austria)."[912] The court concluded:

> The record shows that petitioner actively managed the properties prior to his departure for the United States and that he was in frequent contact with his partner who managed the properties after petitioner left. We are of the opinion, accordingly, that petitioner was regularly engaged in the business of operating the … properties ….

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[910] The court continued:

> In *Anders I. Lagreide*, 23 T.C. 508, 511 , we said:
>
> > The first issue to be considered is whether or not the renting out in 1949, by Alice Lagreide, of a single piece of residential real estate, amounted to the operation by her of a trade or business regularly carried on. She inherited the property from her mother in 1948 and never occupied or maintained it as her own residence. Since the time of the mother's death, the property was either rented or available for renting, and was actually rented during part of 1948 and almost all of 1949.
> >
> > It is clear from the facts that the real estate was devoted to rental purposes, and we have repeatedly held that such use constitutes use of the property in trade or business, regardless of whether or not it is the only property so used. *Leland Hazard*, 7 T.C. 372 (1946). See also *Quincy A. Shaw McKean*, 6 T.C. 757 (1946); *N. Stuart Campbell*, 5 T.C. 272 (1945); *John D. Fackler*, 45 B.T.A. 708, 714 (1941), *affd.* (C.A. 6, 1943) 133 F.2d 509. We add that the use of the property in trade or business was, upon the facts, an operation of the trade or business in which it was so used (see *Industrial Commission v. Hammond*, 77 Colo. 414, 236 Pac. 1006, 1008). It is clear, also, that the business was "regularly" carried on, there having been no deviation, at any time, from the obviously planned use.

[911] Citing "*Gilford v. Commissioner*, 201 F.2d 735, affirming a Memorandum Opinion of this Court."

[912] Citing *Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955).

The NRA handling repairs – even through an agent – seemed to be a tipping point in *Amodio v. Commissioner*, 34 T.C. 894 (1960) (trade or business found),[913] *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*. 221 F.2d 227 (9th Cir. 1955) (trade or business found),[914] and *Herbert v. Commissioner*, 30 T.C. 26, 33 (1958) (isolated minor repairs not a trade or business).[915] Letter Ruling 7904019 asserted that paying mortgages and reimbursing tenant expenses was insufficient to move the taxpayer out of the holding of Rev. Rul. 73-522.[916] However, *Pinchot v.*

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[913] The court held:

> The properties were managed by local real estate agents who negotiated or renewed leases, arranged for repairs, collected rents, paid taxes and assessments, and remitted net proceeds to Fidelity after deducting commissions. From the proceeds Fidelity or the local agent paid principal and interest on the mortgages, insurance premiums, and taxes. Fidelity retained its commissions and amounts to be applied on Amodio's income taxes and the remainder was sent to him. The acts of the agents are attributable to Amodio. These activities were beyond the scope of mere ownership of property and the receipt of income. They were considerable, continuous, and regular, as in the *Lewenhaupt* case. Such activities of a nonresident alien through his agents in the United States constitute engaging in business in the United States. Amodio is taxable as a nonresident alien engaged in trade or business in the United States.

[914] The Tax Court described the agent's activities:

> LaMontagne's activities, during the taxable year, in the management and operation of petitioner's real properties included the following: executing leases and renting the properties, collecting the rents, keeping books of account, supervising any necessary repairs to the properties, paying taxes and mortgage interest, insuring the properties, executing an option to purchase the El Camino Real property, and executing the sale of the Modesto property. In addition, the agent conducted a regular correspondence with the petitioner's father in England who held a power of attorney from petitioner identical with that given to LaMontagne; he submitted monthly reports to the petitioner's father; and he advised him of prospective and advantageous sales or purchases of property.
>
> The aforementioned activities, carried on in the petitioner's behalf by his agent, are beyond the scope of mere ownership of real property, or the receipt of income from real property. The activities were considerable, continuous, and regular and, in our opinion, constituted engaging in a business within the meaning of section 211(b) of the Code. See *Pinchot v. Commissioner*, 113 F.2d 718.

[915] The Tax Court held:

> In the instant case the real property consisted of one building rented in its entirety to one tenant who has occupied it since 1940, has complete charge of its operation, and is responsible for all repairs except as to outer walls and foundation. This property (the only real property owned by petitioner in the United States) was acquired by petitioner 50 years ago, not as the result of a business transaction entered into for profit (*cf. Fackler v. Commissioner*, 133 F.2d 509) but by gift from petitioner's father when she was a very young girl (see *Grier v. United States*, 120 F.Supp. 395). During the taxable years her only activities, in addition to the receipt of rentals, were the payment of taxes, mortgage principal and interest, and insurance premiums. See *Evelyn M. L. Neill*, *supra*. The record also shows that petitioner executed a lease of the property in 1940 and a modified renewal thereof in 1946, and made minor repairs to the walls and roof in 1954 and 1955.
>
> We are of the opinion that petitioner's activities with regard to the real property here involved, which might be considered as "beyond the scope of mere ownership of real property, or the receipt of income from real property," were sporadic rather than "continuous," were irregular rather than "regular," and were minimal rather than "considerable." We therefore conclude that petitioner was "not engaged in trade or business in the United States" during the taxable years within the meaning of article IX (1) of the United States-United Kingdom tax convention.

[916] The IRS pointed out:

> The Lease between Corp M and Corp P, although not identical to the net leases described in Rev. Rul. 73-522, differs only in three respects. One, the lessor rather than the lessee pays real

Commissioner, 113 F.2d 718 (2nd Cir. 1940), held that maintaining a portfolio of 11 rental properties, which probably were not triple-net leases, constituted a business;[917] *Lewenhaupt* cited *Pinchot* with approval.[918]

A small interest in oil & gas that did not influence annual operations did not contribute a trade or business.[919]

> estate taxes imposed on the leased property; two, the lessor rather than the lessee pays installments on existing encumbrances; and three, the lessor, Corp M, pays a yearly fee to the lessee as reimbursement for grass, pest, and weed control and fertilization.

The IRS reasoned:

> With respect to the payment of a yearly fee by Corp M to Corp P as reimbursement for grass, pest, and weed control and fertilization, we note that Corp M does not supervise or participate in any way in the activities for which it pays the fee. Further, the fee is paid once each year and does not involve Corp M in the farming of the land. Consequently, the payment of the fee is sporadic, irregular, and minimal and does not, in and of itself, cause Corp M to be engaged in a trade or business within the United States.

[917] The court summarized the facts and reasoned:

> The essential facts were stipulated and, so far as now important, are that the decedent, Antoinette Eno Johnstone, died July 1, 1934, a British subject and a non-resident. Much of her property in this country consisted of improved real estate in the City of New York owned in common by her and her two brothers of whom one is her executor and the petitioner herein. This real estate was made up of eleven parcels of which the decedent's share had a gross value of about one million dollars. The petitioner, Amos R.E. Pinchot, managed the properties for her and the third owner under broad powers of attorney which included also the management of certain personal property owned by the three. He bought and sold property for the co-owners in his discretion without consulting the decedent who did not personally take part in the transactions. This management "consisted of the leasing and renting of the properties when they became idle, collection of rents and payment of operating expenses, taxes, mortgage interest and other necessary obligations." Over a period of eighteen years five parcels of real estate had been sold and five had been purchased. There were no sales or purchases during the last three years before the decedent's death.
>
> Though the stipulation does not show the number or the amount of the transactions of the petitioner in managing these eleven buildings in New York, it is certain that they must have been considerable in both respects as well as continuous and regular. Their maintenance required the care and attention of the owners and the decedent supplied her part of that by means of her agent and attorney in fact. *Richards v. Commissioner*, 9 Cir., 81 F.2d 369, 106 A.L.R. 249. What was done was more than the investment and re-investment of funds in real estate. It was the management of the real estate itself for profit. Whether or not that was engaging in business within the meaning of federal tax statutes is a federal question which cannot be controlled by state decisions. *Lyeth v. Hoey*, 305 U.S. 188, 59 S.Ct. 155, 83 L.Ed. 119, 119 A.L.R. 410. It necessarily involved alterations and repairs commensurate with the value and number of buildings cared for and such transactions as were necessary constitute a recognized form of business. The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts; and many other things which come within the definition of business in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 31 S.Ct. 342, 55 L.Ed. 389, Ann.Cas.1912B, 1312, and within the commonly accepted meaning of that word. We think the Board was right in deciding that this decedent was engaged in business in this country at the time of her death. The bank deposits in the United States were, therefore, properly treated as property in this country. Our decision in *Higgins v. Commissioner*, 2 Cir., 111 F.2d 795, did not touch the question of real estate management as a business.

[918] See text at end of fn 914.

[919] After citing *Pinchot*, which was discussed in fn 917, *Di Portanova v. U.S.*, 690 F.2d 169 (Ct. Cl. 1982), held:

> In this respect, an oil lease is similar to real estate. "Whether coownership in a mineral lease constitutes the carrying on of a 'trade or business' is dependent upon all the facts and circumstances in the particular case." Rev. Rul. 58-166, 1958-1 C.B. 324, 325.
>
> The oil and gas business is complex. "The proper development of an oil and gas lease requires a high degree of skill and discretion." Rev. Rul. 58-166, 1958-1 C.B. at 326. To be engaged in the oil business requires active involvement, personally or through an agent, in the operation of that business. *Cataphote Corp. v. United States*, 210 Ct.Cl. 125, 143-46, 535 F.2d 1225, 1235-37 (1976); *Wier v. Enochs*, 64-1 U.S.T.C. ¶ 9387 at 92,009, 92,011 (S.D. Miss. 1963); *aff'd* per curiam, 353 F.2d 211 (5th Cir. 1965); *Nemours Corp. v. Commissioner*, 38 T.C. 585, 601 & n.3 (1962) *aff'd* per curiam, 325 F.2d 559 (3d Cir. 1963); *John Provence #1 Well v. Commissioner*, 37 T.C. 376 (1961), *aff'd*, 321 F.2d 840 (3d Cir. 1963).
>
> (3.) The government properly has conceded that the activities of the trusts regarding the properties subject to the 1953 and 1965 agreements do not constitute a trade or business and we so hold. The activities are functionally indistinguishable from the mere receipt of income from investments and the payment of expenses incidental to that receipt. The trusts do not manage or control the field operations or participate actively in them. Indeed, the agreements give Quintana exclusive control over "all operations of every kind." The trusts have little power under the agreements. Moreover, in view of their meager percentage of the total interest and the plaintiff's estrangement from the Cullen family, they also have virtually no informal influence over the operations.
>
> Although the trusts have the right to receive their actual share of the oil and gas produced and Quintana negotiates the sale of the minerals as an agent of the trusts, the Service by its concession recognizes that this is not enough to constitute a trade or business. Considering all the circumstances, we hold that the trusts' activities under the 1953 operating agreement and its amendments did not constitute trade or business.

II.J.18. Trust Divisions, Mergers, and Commutations; Decanting

Although most trust divisions and distributions are not subject to income tax, some changes in a beneficial interest in a trust are.

Trust divisions (part II.J.18.a), mergers (part II.J.18.b), and decanting (part II.J.18.c) may be structured to avoid any income or transfer tax consequences. However, if any beneficial interest is reduced, which is more likely to be the case in a decanting than a straight division or merger (because divisions and mergers generally continue the underlying beneficial interests, and decanting may or may not do so), severe transfer tax consequences may ensue.

If the parties wish to change their beneficial interests without any transfer tax consequences, that change may constitute a commutation (part II.J.18.d), which may generate income tax consequences in that beneficial interests are themselves assets owned by the beneficiaries for income tax purposes, the sale or exchange of which is subjected to income tax.

A nice summary of the above issues is in part II.J.18.e Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations. To me, the income tax question is whether a course of action is more in the nature of a nontaxable continuation of existing beneficial interests – just rearranged somewhat to avoid conflicts in administrative issues resulting from beneficiaries' differing goals or needs – or is a material change in beneficial interests constituting an exchange.

II.J.18.a. Trust Divisions

See part II.D.5 Severing Trusts with Multiple Grantors.

Generally, a partition of jointly owned property is not a sale or other disposition of property when the co-owners of the joint property sever their joint interests.[2707]

Rev. Rul. 69-486 held the following, addressing a trustee mak[2708]ing non-pro rata distributions to beneficiaries C and X:[2709]

[2707] Rev. Rul. 56-437 provides:

> The conversion, for the purpose of eliminating a survivorship feature, of a joint tenancy in capital stock of a corporation into a tenancy in common is a nontaxable transaction for Federal income tax purposes. Likewise, the severance of a joint tenancy in stock of a corporation, under a partition action instituted under sections 103-1-1 to 10 of Colorado Revised Statutes, 1953, compelling partition and the issuance of two separate stock certificates in the names of each of the joint tenants, is a nontaxable transaction. In each case there was no sale or exchange and the taxpayers neither realized a taxable gain nor sustained a deductible loss. See I.T. 1761, C.B. II-2, 56 (1923), holding that although the transfer of stock from the name of an individual to the name under which the individual does business is subject to tax under the stamp tax law (Schedule A-3, Title XI of the Revenue Act of 1921), it is not a sale within the meaning of the income tax law. See also Rev. Rul. 55-77, C. B. 1955-1, 339, and Rev. Rul. 55-179, C.B. 1955-1, 340.

[2708]

[2709] Rev. Rul. 69-486 posited the following facts:

> Under terms of the trust instrument, the trustee is required to distribute currently all trust income to B for her life and upon her death distribute one-half of the trust corpus to C, an individual, and

> Since the trustee was not authorized to make a non-pro rata distribution of property in kind but did so as a result of the mutual agreement between C and X, the non-pro rata distribution by the trustee to C and X is equivalent to a distribution to C and X of the notes and common stock pro rata by the trustee, followed by an exchange between C and X of C's pro rata share of common stock for X's pro rata share of notes.

Being aware of this issue and seeking to avoid it, Uniform Trust Code ("UTC") § 816 (promulgated in 2000 and last revised or amended in 2010) provides that "a trustee may":

> … (22) on distribution of trust property or the division or termination of a trust, make distributions in divided or undivided interests, allocate particular assets in proportionate or disproportionate shares, value the trust property for those purposes, and adjust for resulting differences in valuation ….

The UTC's official Comments include:

> Paragraph (22) authorizes a trustee to make non-pro-rata distributions and allocate particular assets in proportionate or disproportionate shares. This power provides needed flexibility and lessens the risk that a non-pro-rata distribution will be treated as a taxable sale.

> one-half to X, a charitable organization exempt from tax under section 501(c)(3) of the Internal Revenue Code of 1954.
>
> B died on July 1, 1967. At the time of her death, the trust had ordinary income of 20x dollars to be reported in its current calendar year period. Subsequent to B's death the trust received no income up to its termination on August 1, 1967. The distributable net income of the trust for 1967 as defined by section 643(a) of the Code was 20x dollars. The trustee properly distributed currently 20x dollars to B's successor in interest.
>
> At the time of B's death, the trust corpus to be distributed to C and X consisted in part of notes that had been purchased by the trust and that had a total adjusted basis of 300x dollars and a total fair market value of an equal amount. The balance of the trust corpus consisted of common stock acquired by purchase with a total adjusted basis of 100x dollars and a total fair market value of 300x dollars.
>
> The trust instrument as well as local law was silent as to the authority of the trustee to make a non-pro rata distribution of property in kind.
>
> By mutual agreement, the two beneficiaries requested that the trustee distribute all of the notes to C and all of the common stock to X. The trustee complied with this request on August 1, 1967.
>
> The first issue to be decided is how the non-pro rata distribution by the trustee to C and X will be treated for Federal income tax purposes.
>
> [see text in main body]
>
> The second issue to be decided is the basis of the pro rata share of notes and common stock in the hands of C and X.

Rev. Rul. 69-486 reasoned and concluded:

> Inasmuch as the 20x dollars of income required to be distributed currently to the estate of B is equal to the distributable net income of the trust, no amount is includible in the gross income of C and X as a result of the pro rata distribution of notes and common stock by the trustee. See section 662(a) of the Code as implemented by section 1.662(a)-2 of the regulations.
>
> The basis of the pro rata shares of notes and common stock in the hands of C and X is the same as the adjusted basis in the hands of the trust. See section 1.1015-2(b) of the regulations.
>
> Furthermore, C in substance exchanged his pro rata share of common stock with X for X's pro rata share of notes. The amount of recognized gain to C is determined under sections 1001 and 1002 of the Code. Since X is a charitable organization exempt from tax under section 501(c)(3) of the Code, it has no tax consequence as a result of the exchange.

Letter Ruling 200552009, involving trust mergers followed by divisions, is discussed in part II.J.18.b Trust Mergers.

Reg. § 1.1001-1(h), "Severances of trusts," which was issued long after Rev. Rul. 69-486 was released, provides:[2710]

> (1) *In general*. The severance of a trust (including without limitation a severance that meets the requirements of § 26.2642-6 or of § 26.2654-1(b) of this chapter) is not an exchange of property for other property differing materially either in kind or in extent if -
>
> (i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and
>
> (ii) Any non-pro rata funding of the separate trusts resulting from the severance (including non-pro rata funding as described in § 26.2642-6(d)(4) or § 26.2654-1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.
>
> (2) *Effective/applicability date*. This paragraph (h) applies to severances occurring on or after August 2, 2007. Taxpayers may apply this paragraph (h) to severances occurring on or after August 24, 2004, and before August 2, 2007.

Note that the regulation applies to any severance, not just a qualified severance. Reg. § 26.2642-6(j), Example (3), "Severance based on actuarial value of beneficial interests," recognizes the following as a nonqualified severance:

> In 2004, T establishes Trust, an irrevocable trust providing that income is to be paid to T's child C during C's lifetime. Upon C's death, Trust is to terminate and the assets of Trust are to be paid to GC, C's child, if living, or, if GC is not then living, to GC's estate. T properly elects, under section 2632(c)(5), not to have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. Thus, Trust has an inclusion ratio of one. In 2009, the trustee of Trust, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 for the benefit of C (and on C's death to C's estate), and Trust 2 for the benefit of GC (and on GC's death to GC's estate). The document severing Trust directs that Trust 1 is to be funded with an amount equal to the actuarial value of C's interest in Trust prior to the severance, determined under section 7520 of the Internal Revenue Code. Similarly, Trust 2 is to be funded with an amount equal to

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[2710] Reg. § 1.1001-1(h) was promulgated as part of project to facilitate severing trusts for GST purposes. T.D. 9348 (8/2/2007) explained:

> One commentator noted that § 1.1001-1(h)(1) of the proposed regulations provides favorable income tax treatment only with respect to a qualified severance. The commentator requested that the regulations also address the income tax treatment of all other trust modifications and severances. The commentator noted that the failure to address, for example, the income tax consequences of severances that are not qualified severances for GST tax purposes implies that such severances are taxable events for income tax purposes. In response to these comments, the category of severances to which § 1.1001-1(h)(1) will apply has been broadened. No inference should be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in § 1.1001-1(h)(1).

> the actuarial value of GC's interest in Trust prior to the severance, determined under section 7520. Trust 1 and Trust 2 do not provide for the same succession of interests as provided under the terms of the original trust. Therefore, the severance is not a qualified severance. Furthermore, because the severance results in no non-skip person having an interest in Trust 2, Trust 2 constitutes a skip person under section 2613 and, therefore, the severance results in a taxable termination subject to GST tax.

If a trust is divided so that each trust has the same beneficial interests but different assets and trustees, the division itself will not carry out income from one trust to the other.[2711] If a trust divides but distributes property to satisfy a pecuniary obligation to one of the beneficiaries, the latter distribution is a deemed sale, but the rest of the distribution is nontaxable.[2712] If one trust later distributes to another trust as a conduit to make distributions to the beneficiaries, the distribution will carry out DNI; however, if the distribution is just to shift funds between with the trusts without the shift being related to distributions, the shift does not carry DNI.[2713]

Whether a trust division shifts the grantor does not affect whether the division constitutes a distribution that carries out DNI.[2714]

[2711] Letter Ruling 201642028, which is described in detail in part II.J.18.c.ii Tax Consequences of Decanting. For a similar result for decanting, see part II.J.4.i Modifying Trust to Make More Income Tax Efficient.

[2712] Letter Ruling 201722007 held:

> In accordance with the conclusion that the post-equalization property divisions of Trust 1 and Trust 2 will not result in gain or loss under § 61 or § 1001, we also conclude that, based solely on the facts submitted and representations made, the proposed divisions of the post-equalization property will not result in income, gain or loss to the trusts under § 661, § 662, or § 1.661(a)-2(f). Consistent with Rev. Rul. 82-4, gain will be recognized on funding of Successor Trusts to the extent appreciated assets are used to satisfy the Equalization Distribution in kind.

Rev. Rul. 82-4 is described in fn 2553 in part II.J.8.d.i Distribution in Kind - Generally

[2713] Letter Ruling 201642028, which is described in detail in part II.J.18.c.ii Tax Consequences of Decanting.

[2714] T.D. 8831 (8/6/1999), provides:

> Commenters also questioned a provision in the proposed regulations that treated a distribution from one trust to another trust that is a beneficiary of the first trust as a gratuitous transfer, with the result that the first trust was a grantor of the second trust. Under the temporary regulations, if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally is treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, such person is treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Code. (These rules do not affect the determination of whether or not the gratuitous transfer from the transferor trust is a distribution subject to sections 651 or 661.)

See parts II.D.3 Trust as Grantor of a Trust and III.B.2.h.i Who Is the Grantor, the latter including fns. 6177-6180.

Letter Ruling 201928004 held:[2715]

> A partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result thereof. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507 (conversion of a joint tenancy in stock to a tenancy in common in order to eliminate the survivorship feature and the partition of a joint tenancy in stock are not sales or exchanges).
>
> Similarly, divisions of trusts are also not sales or exchanges of trust interests where each asset is divided pro rata among the new trusts. See Rev. Rul. 69-486, 1969-2 C.B. 159 (pro rata distribution of trust assets not a sale or exchange).
>
> In the present case, the legal entitlements, as well as the rights and powers, of the beneficiaries will remain the same in kind and extent after the Proposed Division of Trust into the Subtrusts. Accordingly, based on the facts submitted and representations made, the Proposed Division of Trust will not result in the realization of gain or loss under § 61 and § 1001.
>
> Moreover, based on the facts submitted and representations made, we conclude that the Proposed Division is not a distribution under § 661 or § 1.661(a)-2(f). We further conclude that the Proposed Division of Trust assets among the Subtrusts will not cause Trust, the Subtrusts, or beneficiaries to recognize any income, gain, or loss under § 662.

II.J.18.b. Trust Mergers

For trust mergers, followed by divisions, Letter Ruling 200552009 stated:

> We also conclude that because § 1001 does not apply to the proposed division of merged Trust 4, under § 1015, the tax basis that the New Trusts have in the assets of the New Trusts immediately after the division will be the same as the tax basis of the merged Trust 4 in such assets immediately before the division. The tax basis of the historic assets in the New Trusts immediately after the division will be the same as the tax basis that the merged Trust 4 had in those assets immediately before the division. We further conclude that each asset transferred by the merged Trust 4 to the New Trusts will have the same holding period in the hands of the New Trusts immediately after the division that it had in the hands of the merged Trust 4 immediately before the division. Each historic asset of the New Trusts will have the same holding period immediately after the division that it had immediately before the division.
>
> We additionally conclude that in each of the mergers of the Family Trusts into Trust 4, the merged Trust 4 will succeed to and take into account any net operating loss carry forward (NOLCF), net capital loss, and other tax attributes, including passive activity losses and

[2715] For the facts in Letter Ruling 201928004, see text following fn 2638 in part II.J.9.c Multiple Trusts Created for Tax Avoidance. The ruling also held:

> Based on the facts submitted and the representations made, we conclude that because § 1001 does not apply to the Proposed Division, under § 1015 the basis of the assets received by Subtrusts will be the same as the respective basis of the assets held by Trust. We further conclude that under § 1223(2) the holding period of the assets received by the Subtrusts will be the same as the holding period of the assets in Trust.

credit carryforwards, of the merging Family Trusts. Each asset transferred by the merging Family Trusts to the merged Trust 4 will have the same tax attributes immediately after the merger that it had immediately before the merger. Each historic asset of the merged Trust 4 will have the same tax attributes immediately after the merger that it had immediately before the merger. All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the merging Family Trusts immediately before the mergers will survive and remain available to the merged Trust 4 after the mergers and no limitation will be imposed as a result of the proposed mergers on the merged Trust 4 's use of such tax attributes.

Finally, we conclude that on the division of the merged Trust 4 into New Trusts, each of the New Trusts will succeed to and take into account c of any net operating loss carry forward (NOLCF), net capital loss, and other tax attributes, including passive activity losses and credit carryforwards, of the divided merged Trust 4. Each asset transferred by the divided merged Trust 4 to the New Trusts will have the same tax attributes immediately after the division that it had immediately before the division. Each historic asset of the New Trusts will have the same tax attributes immediately after the division that it had immediately before the division. All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the divided merged Trust 4 immediately before the division will survive and remain available to the divided New Trusts after the division and no limitation will be imposed as a result of the proposed division on the New Trusts' use of such tax attributes.

Letter Ruling 200743019 held:

In this case, State Statute clearly authorizes the consolidation or merger of trusts by the trustees where the merger or consolidation is in the best interests of the beneficiaries. Moreover, the terms of the trust instruments establishing the original trusts authorize the trustees to execute the necessary documents in order to carry out the powers granted the trustees with respect to the transfer of assets from the trusts. By virtue of the trust powers granted to the trustees under the State Statute and the original trust instruments, the trustees of the original trusts are authorized to merge the assets into the new trusts and to transfer trust assets from the original trusts to the new trusts. Consequently, the beneficiaries of the new trusts are acquiring their interests in the new trusts by reason of the exercise of the trustees' existing authority under state law to merge or consolidate the original trusts and to transfer the trust assets in furtherance of this merger. The beneficiaries are not therefore acquiring their interests in the new trusts as a result of the exchange of their interests in the original trusts, or as the result of an exchange of interests between themselves. Accordingly, there does not appear to be any reciprocal exchange involving the legal rights and entitlements of the beneficiaries under the trusts here. Because no "exchange" has occurred for purposes of § 1001, it is unnecessary to analyze whether the "materially different" standard has been satisfied.

We therefore conclude that the proposed mergers of the original trusts into the new trusts, and the transfer of assets from the original trusts to the new trusts, will not cause the original trusts, the new trusts, or any of the income beneficiaries to recognize any gain or loss under § 1001 from a sale or other disposition of property. Because § 1001 does not apply to the division of Trust 1 assets, under § 1015 the basis of the trust assets will be the same after the proposed transaction as the basis of those assets in the original trusts. Furthermore, pursuant to § 1223(2) the holding periods of the assets in the hands of the new trusts will include the holding periods of the assets in the hands of the original trusts.

If a trust merger constitutes a transfer from one taxpayer to another taxpayer, be sure to make a timely ESBT election.[2716]

II.J.18.c. Decanting

II.J.18.c.i. What Is Decanting

Generally, decanting is the trustee distributing assets from one trust to another trust. For over 100 years, it has been a tool to allow a trustee to change a trust's terms in some manner – whether to facilitate administration or to change a beneficial interest.

For what decanting is, see Uniform Trust Decanting Act, found at http://www.uniformlaws.org/Act.aspx?title=Trust Decanting, with the drafting committee's work found at http://www.uniformlaws.org/Committee.aspx?title=Trust%20Decanting; R.S.Mo. § 456.4-419, found at http://www.moga.mo.gov/mostatutes/stathtml/45600404191.html. The Uniform Trust Decanting Act authorizes amending a trust without transferring assets,[2717] a power that makes decanting a QSST much more comfortable, given that a QSST may not distribute principal other than outright to the beneficiary.[2718]

II.J.18.c.ii. Tax Consequences of Decanting

Because decanting originally took the form of distributing from one trust to another, it may be the same as or similar to a trust division. See part II.J.18.a Trust Divisions. Similarly, when a trustee decants by creating a new trust and merging the old trust into it, it can be viewed as a merger. See part II.J.18.b Trust Mergers.

Be sure to consider whether a decanting that reduces a beneficiary's interest in a trust may be valued under Code § 2702 as a gift of the beneficiary's entire interest in the trust, without any reduction for what the beneficiary retained. For this rule and trying to plan around it, see part III.B.7.d Code § 2702 Overview.[2719]

Decanting does not change who is the grantor under the grantor trust rules, even if a beneficiary is deemed to have made a gift.[2720]

[2716] See Letter Ruling 201941006, described in the text accompanying fn 5616 in part III.A.3.e.ii.(a) Qualification as an ESBT.

[2717] Uniform Trust Decanting Act § 2(23)(A), authorizes amending a trust without transferring assets. The official Comments state:

> Thus the authorized fiduciary may exercise the decanting power by modifying the first trust, in which case the "second trust" is merely the modified first trust. The decanting instrument can, when appropriate, merely identify the specific provisions in the first trust that are to be modified and set forth the modified provisions, much like an amendment to a revocable trust. If the decanting power is exercised by modifying the terms of the first trust, the trustee could either treat the second trust as a new trust or treat the second trust as a continuation of the first trust. If the second trust is treated as a continuation of the first trust, there should be no need to transfer or retitle the trust property. Further, subject to future tax guidance, if the second trust is a continuation of the first trust, there may be no need to treat the first trust as having terminated for income tax purposes and no need to obtain a new tax identification number.

[2718] See fn 5581 and accompanying text in part III.A.3.e.i.(a) QSSTs Generally.

[2719] Especially text accompanying fns 6851-6860.

[2720] See part III.B.2.h.i Who Is the Grantor, especially fn 6177.

ACTEC comments on decanting (http://www.actec.org/resources/comments-on-transfers-by-a-trustee) proposed a revenue ruling saying no new tax ID but do not cite authority for that conclusion. However, they mentioned that Letter Ruling 200607015 treated a decanted trust[2721] as a continuation of the original trust.[2722] On the other hand, they also referred to Letter Ruling 200736002, which involved a trust division and also treated the division as being a continuation and not a distribution,[2723] but the three successor trusts were treated as different trusts from each other, which means that at least two trusts needed to get new tax IDs. So I don't know how much to read into whether being considered a continuation trust would require a tax ID.

Combination merger and decanting: When identical trusts merged into a new trust that was identical other than administrative trustee issues, Letter Ruling 200743022 held no change in grandfathered-GST status and:

> In this case, State Statute clearly authorizes the consolidation or merger of trusts by the trustees where the merger or consolidation is in the best interests of the beneficiaries. Moreover, the terms of the trust instruments establishing the original trusts authorize the trustees to execute the necessary documents in order to carry out the powers granted the trustees with respect to the transfer of assets from the trusts. By virtue of the trust powers granted to the trustees under the State Statute and the original trust instruments,

[2721] Letter Ruling 200607015 described decanting as an inter vivos power of appointment held by a trustee:

> State 1 law permits a trustee who has absolute discretion, under the terms of a trust, to invade the principal for the benefit of one or more proper object of the exercise of the power, to exercise such discretion by appointing all or part of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created or under the same instrument, provided, however that the exercise of such discretion does not reduce any fixed income interest of any income beneficiary of the trust and is in favor of the proper objects of the exercise of the power. The State 1 law provides that the trustee may act without the consent of any interested person and without prior court approval. The Trustees herein represent that they will petition the appropriate court and provide notice to all interested parties.

However, section 2(17) of the Uniform Trust Decanting Act takes a different approach:

> "Power of appointment" means a power that enables a powerholder acting in a nonfiduciary capacity to designate a recipient of an ownership interest in or another power of appointment over the appointive property. The term does not include a power of attorney.

Rather, section 2(10) of the Uniform Trust Decanting Act views decanting as a fiduciary distribution:

> "Decanting power" or "the decanting power" means the power of an authorized fiduciary under this [act] to distribute property of a first trust to one or more second trusts or to modify the terms of the first trust.

[2722] Letter Ruling 200607015 held:

> Based solely on the facts and the representations submitted, we conclude that the trustees' appointment of the four Trusts into four New Trusts will not be viewed as a distribution or termination under § 661 or § 1.661(a)-2(f)(1) and should therefore not result in the realization by the Trusts, the New Trusts, or any beneficiary of any of the Trusts of any of the New Trusts, of any income, gain , or loss under §§ 661 and 662.

[2723] Letter Ruling 200736002 held:

> Based upon the facts submitted and the representations made, we conclude that because the creation of the successor trusts is a modification of Trust for Federal income tax purposes, the successor trusts are treated as a continuation of Trust. Therefore, the transfer of assets from Trust to the successor trusts will not be treated as a distribution or termination under § 661, and will not result in the realization by Trust, the successor trusts, or by any beneficiary of Trust or the successor trusts of any income, gain, or loss.

> the trustees of the original trusts are authorized to merge the assets into the new trusts and to transfer trust assets from the original trusts to the new trusts. Consequently, the beneficiaries of the new trusts are acquiring their interests in the new trusts by reason of the exercise of the trustees' existing authority under state law to merge or consolidate the original trusts and to transfer the trust assets in furtherance of this merger. The beneficiaries are not therefore acquiring their interests in the new trusts as a result of the exchange of their interests in the original trusts, or as the result of an exchange of interests between themselves. Accordingly, there does not appear to be any reciprocal exchange involving the legal rights and entitlements of the beneficiaries under the trusts here. Because no "exchange" has occurred for purposes of § 1001, it is unnecessary to analyze whether the "materially different" standard has been satisfied.
>
> We therefore conclude that the proposed mergers of the original trusts into the new trusts, and the transfer of assets from the original trusts to the new trusts, will not cause the original trusts, the new trusts, or any of the income beneficiaries to recognize any gain or loss under § 1001 from a sale or other disposition of property. Because § 1001 does not apply to the division of Trust 1 assets, under § 1015 the basis of the trust assets will be the same after the proposed transaction as the basis of those assets in the original trusts. Furthermore, pursuant to § 1223(2) the holding periods of the assets in the hands of the new trusts will include the holding periods of the assets in the hands of the original trusts.

Letter Ruling 201642028 involved the following facts:

> On Date 1, a date prior to September 25, 1985, Husband and Wife created five irrevocable trusts with substantively similar terms for different beneficiaries. Trust 1 was created for the primary benefit of Grandchild 1, Trust 2 was created for the primary benefit of Grandchild 2, Trust 3 was created for the primary benefit of Grandchild 3, Trust 4 was created for the primary benefit of Daughter, and Trust 5 was created for the primary benefit of Grandchild 4.
>
> Article I of Trust 1 provides that the trustees are to pay to or for the benefit of Grandchild 1 so much of the net income from Trust 1 as the trustees in their sole discretion shall determine to be necessary and desirable to provide for the health, education, maintenance, and support (HEMS) of said beneficiary. In the event that net income is not sufficient to provide for the health, education, maintenance, and support of said beneficiary, then the trustees may use such part of the principal as, from time to time, in their sole discretion, they may determine to be necessary for such purposes.
>
> Article II of Trust 1 provides that, upon the death of Grandchild 1, the trustees are to pay to or for the benefit of the issue of Grandchild 1 such part of the net income from Trust 1 as the trustees in their sole discretion shall determine to be necessary and desirable to provide for the health, education, maintenance, and support of such issue. In the event that the trustees determine that the net income is not sufficient to provide for the health, education, maintenance, and support of any one or more of such issue, then the trustees may use such part of the principal as, from time to time, in their sole discretion, they may determine to be necessary for such purposes.
>
> Article III of Trust 1 provides that, in the event that Grandchild 1 and all issue of Grandchild 1 shall die prior to the final distribution of Trust 1 properties, the remaining Trust 1 properties, principal, and any accumulated income, shall be paid over and

delivered in equal shares among the other trusts (Trust 2, Trust 3, Trust 4, and Trust 5) then in existence.

Article XII of Trust 1 provides that Trust 1 will terminate 21 years after the last to die of Grandchild 1, Grandchild 2, Grandchild 3, Daughter, or Grandchild 4. Upon termination, all of the properties remaining in Trust 1 shall be distributed to the then living beneficiaries of Trust 1, share and share alike.

Trust 1 appoints seven initial individual trustees and Article VIII of Trust 1 identifies seven successor individual trustees of Trust 1. Article VIII of Trust 1 additionally provides that when fewer than four trustees are currently serving, the remaining trustees shall have the power and authority to appoint one or more individuals as trustees, so that at least four and not more than seven individuals may serve as trustees. Further, Article VIII of Trust 1 grants the trustees then serving the power to appoint a bank as successor trustee, to serve thereafter as the sole trustee.

Grandchild 4 died in Year without issue. Pursuant to the terms of Trust 5, the assets remaining after the death of Grandchild 4 were distributed equally among Trust 1, Trust 2, Trust 3, and Trust 4.

Currently, Trust 1, Trust 2, and Trust 3 (the GC Trusts) hold limited partnership interests in LP1 and LP2 and shares of Corporation 1 and Corporation 2. Corporation 1 is a bank holding company and Corporation 2 is a closely-held corporation. Each of the GC Trusts' interests in LP2 and Corporation 2 is a significant percentage (approximately a percent) of the GC Trusts' net value, with the remaining assets consisting of cash and marketable securities.

Currently, Individual 1, Individual 2, Individual 3, Individual 4, Individual 5, and Individual 6 (the current individual trustees) serve as co-trustees of Trust 1, Trust 2, Trust 3, and Trust 4.

On Date 2, Grandchild 1 petitioned State Court, pursuant to State Statute, to modify Trust 1, specifically requesting the appointment of a corporate trustee to replace the current individual trustees. Grandchild 2, Grandchild 3, and Daughter filed similar petitions for modifications to the respective trust of which each is a beneficiary. The petitions allege that the current individual trustees failed to sufficiently communicate with the beneficiaries of the trusts concerning the investment strategies for each of the respective trusts and the respective beneficiary's needs in relation to his or her health, education, support, and maintenance. In addition, the petitions filed by Grandchild 1, Grandchild 2, and Grandchild 3 allege that the current individual trustees failed to sufficiently diversify trust assets and made questionable investments despite the potential for conflicts of interests. The current individual trustees denied the allegations in the petitions and opposed the request to appoint a corporate trustee for each trust.

After an extended period of negotiations, including mediation, Grandchild 1, Grandchild 2, Grandchild 3, Daughter, and the current individual trustees entered into Settlement Agreement, which State Court approved by order dated Date 3. Settlement Agreement is contingent on the receipt of favorable rulings from the Internal Revenue Service.

Settlement Agreement provides for similar modifications to apply to each of Trust 1, Trust 2, and Trust 3. In regard to Trust 1, Settlement Agreement provides as follows: (1) Trust 1 will be divided into Successor Trust and Trust A; (2) Bank will be appointed to serve as the sole corporate trustee of Successor Trust; (3) Individual 1, Individual 2, and Individual 3 will be appointed to serve as co-trustees of Trust A; (4) Successor Trust and Trust A will have the same beneficiaries in the same proportions as Trust 1; (4) Successor Trust will be funded with the balance of Trust 1 assets after the funding of Trust A; (5) Trust A will be funded with Trust 1's partnership interests in LP1 and LP2 and shares of Corporation 1 and Corporation 2, and $b in cash or other liquid assets; (6) Successor Trust and Trust A will be governed by the same terms found in the Trust 1 instrument, except as modified by Settlement Agreement. Trust 4 will not be divided, but Bank will be appointed to serve as the sole corporate trustee of Trust 4.

Settlement Agreement provides that the trustee provision of Trust 1 will be modified in the trust instrument governing Successor Trust to provide the “distributees” of Successor Trust, upon application to and order of State Court at State Court's discretion, the power to remove at any time and without cause any then-serving corporate trustee of Successor Trust by written notice delivered to such trustee, and the power to replace such trustee with another corporate trustee that—(1) has the power to act as a trustee under the laws of the state governing the administration of the trust; (2) has at least $c in assets under management; and (3) is not related or subordinate, within the meaning of § 672(c), to the “distributees” of Successor Trust. Further, the trustee provision of Trust 1 will be modified in the trust instrument governing Successor Trust to provide the “distributees” of Successor Trust, in the event the then-serving corporate trustee resigns or can no longer serve as trustee, the power to appoint a successor corporate trustee, without application to and approval by State Court, that— (1) has the power to act as a trustee under the laws of the state governing the administration of the trust; (2) has at least $c in assets under management; and (3) is not related or subordinate, within the meaning of § 672(c), to the “distributees” of Successor Trust. The term “distributees” refers to a majority of the competent adult beneficiaries who are at the time authorized to receive distributions of principal or income from the trust.

Settlement Agreement provides that the trustee provision of Trust 1 will be modified in the trust instrument governing Trust A so that the number of individuals serving as co-trustees of Trust A shall be three as of the date of the division of Trust 1 into Successor Trust and Trust A. Upon the first of Individual 1, Individual 2, or Individual 3, to die, resign, become incapacitated, or otherwise fail to serve, the distributees of Trust A will be empowered to select one individual to serve as successor trustee of Trust A. The trustee selected by the distributees will be subject to the approval of the other two then-serving trustees. Succession to the office of trustee for the other two trustees shall continue to be determined by the co-trustees.

Under Settlement Agreement, the beneficiaries of Trust A agree to look to, and the trustees of Trust A agree to utilize, the income and principal of Successor Trust first for the beneficiaries' HEMS distributions. Settlement Agreement provides that the governing instrument of Trust A will provide that in making distributions in accordance with the HEMS standard, the trustees are to take into consideration a beneficiary's distributions of income and principal received from Successor Trust and other sources of income.

Settlement Agreement provides that the beneficiaries of Trust A and the beneficiaries of Successor Trust are and will be the same and each beneficiary has an identical interest in Trust A as he or she has in Successor Trust. However, Settlement Agreement provides that the trustees of Trust A will make all transfers and distributions to the trustee of Successor Trust in order to satisfy any transfers or distributions the trustees of Trust A may be required to make to Successor Trust or its beneficiaries under the governing instrument of Trust A, by law, or under Settlement Agreement, so that no distributions will be made directly from Trust A to the beneficiaries.

The termination date of Successor Trust is the termination date of Trust 1, which is 21 years after the last to die of Grandchild 1, Grandchild 2, Grandchild 3, Daughter, or Grandchild 4. Settlement Agreement provides that the governing instrument of Trust A will provide for a termination date d years after the effective date of Settlement Agreement, unless trustee of Successor Trust elects, after consultation with the distributees of Successor Trust, to extend the termination date of Trust A for an additional e years. Since the sum of d years and e years is less than 21 years, and Grandchild 1, Grandchild 2, Grandchild 3, and Daughter were all alive on the effective date of Settlement Agreement, the termination date of Trust A will be before the termination date of Successor Trust. Upon termination of Trust A, the assets of Trust A will be distributed to the trustee of Successor Trust to form part of the corpus of Successor Trust.

After the modification, both Successor Trust and Trust A continue to be subject to the rule in Article III of Trust 1, which provides that in the event that Grandchild 1 and all issue of Grandchild 1 all predecease the required termination date, the remaining trust assets will be distributed equally to the other trusts (Trust 2, Trust 3, Trust 4, and Trust 5) then in existence.

Under Settlement Agreement, attorneys' fees and expenses incurred by the trustees and beneficiaries relating to the litigation and the Settlement Agreement will be paid or reimbursed by Trust 1, Trust 2, Trust 3, and Trust 4. The direct payments and reimbursements shall be made from each of Trust 1, Trust 2, Trust 3, and Trust 4, pro rata, in relation to the total value of each trust.

Finally, Settlement Agreement includes several provisions that concern the trustees' administration of Successor Trust and Trust A, such as provisions addressing communications with beneficiaries and conflicts of interest.

The current individual trustees of Trust 1 represent that no other additions have been made to Trust 1 since September 25, 1985.

Under the law of State, in administering a distribution standard tied to the needs of a beneficiary, a trustee will consider all income enjoyed by the beneficiaries from any and all sources, so long as it is available for support of the beneficiary. Citation.

As to GST issues, Letter Ruling 201642028 concluded:

With regard to the proposed modifications of Trust 1, we conclude:

a The division of Trust 1 pursuant to the terms of Settlement Agreement will not shift any beneficial interest in Trust 1 to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division will not extend the time for vesting of any beneficial interest in Trust 1 beyond the period provided for in the original trust. Therefore, the two trusts resulting from the division, Successor Trust and Trust A, will not be subject to the provisions of chapter 13.

b The modification of Trust 1 pursuant to the terms of Settlement Agreement to provide for a change in trustee and to modify the trustee succession procedures is viewed as pertaining to the administration of the trust, comparable to the administrative modification in Example 10 of § 26.2601-1(b)(4)(i)(E).

c In addition, all other terms and trust modifications set forth in Settlement Agreement (including the trustee procedures regarding HEMS distributions, the payment of attorneys' fees, trustee communications with beneficiaries, and conflicts of interest) are viewed as 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 1.

> Accordingly, based upon the facts submitted and the representations made, we further conclude that after the division and modification of Trust 1 pursuant to Settlement Agreement, Trust 1, Successor Trust, and Trust A will not be subject to the provisions of chapter 13.

Letter Ruling 201642028 viewed the beneficial interests as not changing, so the modification did not have any gift or estate tax consequences. Because the trustees could makes distributions only for ascertainable standards, the right to change trustees also had no estate tax consequences. As to income tax issues:

> … the division of Trust 1 into Successor Trust and Trust A pursuant to the Settlement Agreement will not result in a distribution under § 661 from Trust 1; and accordingly, will not result in gross income to Successor Trust or Trust A under § 662. Additionally, we conclude that a transfer from Trust A to Successor Trust pursuant to the Settlement Agreement that is made for a purpose other than to facilitate a HEMS distribution to a beneficiary will not result in a distribution under § 661 from Trust A; and accordingly, will not result in gross income to Successor Trust under § 662.
>
> We further conclude that a transfer from Trust A to Successor Trust for an immediate HEMS distribution to a beneficiary will result in a deduction pursuant to § 661 for Trust A (to the extent of Trust A's distributable net income) and (ii) inclusion of an equivalent amount in the recipient beneficiary's gross income pursuant to § 662.

Letter Ruling 201642028 also allowed the trusts to reimburse the beneficiaries' legal fees and deduct them as Code § 212 expenses:[2724]

> Legal fees relating to the proper investment of trust assets are a function of the management of the trust property and are deductible if they are ordinary and necessary. *Trust of Bingham v. Commissioner*, 325 U.S. 365, 376 (1945). In *Herman A. Moore Trust v. Commissioner*, 49 T.C. 430 (1968), *acq*., 1968-2 C.B. 21, the Service challenged the trustee's deduction of certain attorneys' fees in computing the trust's

[2724] For Code § 212, see part II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.

income. These fees arose from an action brought by the testator's children to accelerate their beneficial interests in the trust. Pursuant to state law, the court ordered that the attorneys' fees for the trust, the beneficiaries and the guardian ad litem be paid from trust income. The court decided that (1) the state court decision aided the trustee in its management of the trust property, and (ii) the trust benefitted by the involvement of the beneficiaries and the guardian ad litem in the litigation. Thus, the court held that all of the litigants' attorneys' fees paid from trust income were deductible under § 212(2).

In the present case, the legal fees paid by beneficiaries seeking to change the trustee of the trust are not payments to acquire, create, or facilitate the acquisition or creation of an intangible. The litigation involved only the proper administration of the trust and not the beneficiaries' ownership interests in the trust. The beneficiaries already had an ownership interest in the trust and were not seeking a redetermination of that ownership interest, but rather, merely a change in the administration of the trust. Therefore the legal fees are not subject to capitalization under § 1.263(a)-4.

Based on the facts submitted and the representations made, we conclude that the purpose of the action brought by the beneficiaries of Trust 1 was to improve the investment of the assets of the trust. Further, Trust 1 benefited by the involvement of the beneficiaries in the proceedings. Thus, subject to allocations under § 1.265-1, we conclude that the attorneys' fees paid by Trust 1, Successor Trust, or Trust A to a beneficiary of Trust 1, Trust 2, Trust 3, Trust 4, or one of the resulting divided trusts pursuant to Settlement Agreement as reimbursement for the beneficiary's prior payment of attorney's fees and expenses will result in a deduction for the reimbursing trust under § 212. Since the attorney's fees and expenses are deductible under § 212, it is implicit that those expenses are not deductible under § 661 or includible by the beneficiaries under § 662.

Letter Ruling 201711002 involved the following facts:

On Date 1, Settlor established Trust A, an irrevocable trust, for the benefit of Settlor's granddaughter (Granddaughter), Granddaughter's spouse (Spouse), and Granddaughter's children, GGC1 and GGC2, and Granddaughter's issue. Date 1 is a date before September 25, 1985. Trust A was governed by the laws of State 1.

Trust A provides that, during Granddaughter's life, the trustees shall distribute one-half of the net income to Granddaughter. The corporate trustee, in its absolute discretion, may direct the trustees to distribute the other one-half of the net income to Granddaughter and any of her children or issue. Further, the corporate trustee, in its absolute discretion, may direct the trustees to distribute principal to Granddaughter, Granddaughter's children or issue, but none to Granddaughter's husband, as the corporate trustee deems necessary for the support, maintenance, and education of such person.

Trust A provides that when Granddaughter dies, if Spouse predeceases her, then the corporate trustee, in its absolute discretion, may direct the trustees to distribute the entire net income to Granddaughter's children or issue.

Trust A provides that the trust will terminate (Termination Date) upon the death of the last survivor of Granddaughter, Spouse, GGC1, and GGC2 (measuring lives). Upon termination, the trust will be divided into equal shares to Granddaughter's children as are living at the death of the last survivor and to the then living issue of each child of

Granddaughter who is deceased, the issue of each deceased child of Granddaughter to take per stirpes a share equal to the share which a child of Granddaughter would have taken if alive. If upon the Termination Date, there are no living children or issue of Granddaughter, then the trust estate will pass to Settlor's Grandson, and if he is deceased, to Grandson's issue, per stirpes. If none, the trust estate will pass, in equal shares, one-half to University A and one-half to University B.

After Spouse died, on Date 5, Trust A was divided, pursuant to court order and the statutes of State 1, into three separate trusts, one trust to benefit Granddaughter and her issue (Trust A1), one trust to benefit Granddaughter, GGC1 and GGC1's issue (Trust A2), and one trust to benefit Granddaughter, GGC2 and GGC2's issue (Trust A3). Trust A1 received one-half of the assets of Trust A. Trusts A2 and A3 each received one-half of the remaining assets.

Trust A1 provided that during Granddaughter's life, the trustees must pay Granddaughter all of the net income from the trust and the corporate trustee, in its sole discretion, may direct the trustees to distribute so much of the principal to Granddaughter and her issue, as the corporate trustee deems necessary for the support, maintenance, and education of such person. Upon Granddaughter's death, the remaining assets of Trust A1 would be distributed one-half to Trust A2 and one-half to Trust A3. Trust A1 retained the same Termination Date of Trust A. Upon the Termination Date, Trust A1 assets would be distributed in equal shares to Trust A2 and Trust A3. In the event, Granddaughter died without leaving children or issue, Trust A1 assets would be distributed, per stirpes, to Grandson's issue. If none, to University A and University B, in equal shares.

Trust A2 provided that the corporate trustee, in its sole discretion, may direct the trustee to distribute so much of the entire net income to Granddaughter, GGC1 and any of GGC1's issue. Any net income not distributed would be accumulated. Further, the corporate trustee, in its sole discretion, may direct the trustee to pay or expend for the benefit of Granddaughter, GGC1 and GGC1's issue any portion of the net income and so much of the principal as the corporate trustee deems necessary for the support, maintenance, and education of such person. Trust A3 contained the same provisions, except the beneficiaries included Granddaughter, GGC2 and GGC2's issue. Each trust retained the same Termination Date as Trust A. Upon the Termination Date, Trust A2 assets would be distributed to GGC1's children and to the then living issue of a deceased child, such issue to take per stirpes. Upon the Termination Date, the same provisions applied to Trust A3, except that the trust assets would be distributed to GGC2's children or issue. Trusts A2 and A3 also provided that, upon the Termination Date, in the event GGC1 or GGC2 died without leaving issue, the assets in his trust would be distributed in equal shares to his brothers' children or issue. Further, in the event, upon the Termination Date, GGC1 and GGC2 die without leaving children or issue, then the trust assets would be distributed to Grandson's issue. If none, the trust assets would be distributed, in equal shares, to University A and University B.

After Granddaughter died, on Date 6, pursuant to court order and the statutes of State 1, Trust A2 was divided into six separate trusts. Trust 1 benefits GGC1, GGGC1 and GGGC1's issue. Trust 2 benefits GGC1, GGGC2 and GGGC2's issue. Trust 3 benefits GGC1 and GGC1's children and issue. Three other trusts (Trusts X, Y, and Z) were established to benefit GGC1's other children and that child's issue. This private letter ruling pertains to Trust 1, Trust 2, and Trust 3.

Trust 1 provides that the trustees are authorized to distribute so much of the net income, as the corporate trustee determines, in its absolute discretion, to GGC1, GGGC1 and GGGC1's issue. Further, the trustees are authorized to distribute so much of the principal for the support, maintenance, and education of GGC1, GGGC1 and GGGC1's issue, as the corporate trustee, in its sole discretion, determines appropriate. Trust 2 contains the same provisions, except that the beneficiaries include GGC1, GGGC2 and GGGC2's issue. Trust 3 provides that the trustees are authorized to distribute so much of the net income, as the corporate trustee determines, in its absolute discretion, to GGC1 and GGC1's issue. Further, the trustees are authorized to distribute so much of the principal for the support, maintenance, and education of GGC1 and GGC1's issue as the corporate trustee, in its sole discretion, determines appropriate.

Trusts 1, 2, and 3 retain the same Terminate Date as Trust A. Upon the termination Date, Trust 1 assets will be distributed outright to GGGC1, if living. Trust 2 assets will be distributed outright to GGGC2, if living, and Trust 3 assets will be distributed in equal shares to Trusts 1, 2, X, Y, and Z.

On Date 2, Settlor established Trust B, a revocable trust, for the benefit of Granddaughter, GGC1, and GGC2. Trust B was amended and restated on Date 3. Trust B became irrevocable upon Settlor's death on Date 4. Dates 2, 3 and 4 are all dates prior to September 25, 1985. Trust B contains the same income and principal distribution provisions, Termination Date, and dispositive provisions as Trust A, except that Spouse was not a beneficiary or a measuring life.

On Date 5, pursuant to court order and the statutes of State 1, Trust B was divided into three separate trusts, one trust to benefit Granddaughter and her issue (Trust B1), one trust to benefit Granddaughter, GGC1 and GGC1's issue (Trust B2), and one trust to benefit Granddaughter, GGC2 and GGC2's issue (Trust B3). These trusts contain the same provisions as the three divided trusts under Trust A.

After Granddaughter died, on Date 7, pursuant to court order and the statutes of State 1, Trust B2 was divided into six separate trusts. Trust 4 benefits GGC1, GGGC1 and GGGC1's issue. Trust 5 benefits GGC1, GGGC2 and GGGC2's issue and Trust 6 benefits GGC1 and GGC1's issue. Three other trusts (Trusts L, M, and N) were established, one for each of GGC1's other children and each child's issue. This private letter ruling pertains to Trusts 4, 5, and 6.

Trusts 4 and 5 contain the same income and principal provisions, Termination Date, and dispositive provisions as Trusts 1 and 2, respectively. Trusts 6 contains the same income and principal provisions, Termination Date, and dispositive provisions as Trust 3, except that on termination Trust 6 assets will be distributed equally to Trusts 4, 5, L, M, and N. The current trustee of Trusts 1 through 6 is Trustee.

It is represented that no additions, actual or constructive, have been made to Trust A, Trust B, or Trusts 1 through 6 after September 25, 1985.

GGC1 and Trustee propose to establish six new trusts, Trusts 7 through 12, for the purpose of merging Trusts 1 through 6 into the newly established trusts. Trust 1 and Trust 4 benefit GGC1, GGGC1 and GGGC1's issue. Each of these trusts will merge into Trust 7 and Trust 10, respectively. Trusts 7 and 10 will retain the same income and principal distribution provisions as merged Trusts 1 and 4. Trusts 7 and 10 will not terminate until GGGC1 dies, as opposed to upon the death of the last to die of GGC2 and GGC1. However, Trusts 7 and 10 each grant GGGC1 a testamentary general power of appointment to appoint the trust assets of these trusts to GGGC1's issue and the creditors of GGGC1.

Trust 2 and Trust 5 benefit GGC1, GGGC2 and GGGC2's issue. Each of these trusts will merge into Trust 8 and Trust 11, respectively. Trusts 8 and 11 will retain the same income and principal distributions provisions as merged Trusts 2 and 5. Trusts 8 and 11 will terminate when GGGC2's dies, as opposed to upon the death of the last to die of GGC1 and GGC2. However, Trusts 8 and 11 each grant GGGC2 a testamentary general power of appointment to appoint the trust assets of these trusts to GGGC2's issue and the creditors of GGGC2.

Trust 3 and Trust 6 benefit GGC1 and GGC1's issue. Each of these trusts will merge into Trust 9 and Trust 12, respectively. Trusts 9 and 12 will retain the same income and principal distributions provisions as merged Trusts 3 and 6. Upon the death of the last to die of GGC1 and GGC2, Trust 9 will terminate and distribute in equal shares to Trusts 7, 8, X, Y and Z, and Trust 12 will terminate and distribute in equal shares to Trusts 10, 11, L, M, and N.

In addition, Trusts 7, 8, and 9, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust A was created, and Trusts 10, 11, and 12, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust B became irrevocable.

At the time Trusts 7 and 10 terminate, to the extent GGGC1 has not exercised her testamentary general power of appointment, the trustees shall distribute Trust 7 and 10 to GGGC1's then living issue, per stripes, and if no such issue is then living, then to GGC1's issue, per stirpes. Similarly, at the time Trusts 8 and 11 terminate, to the extent GGGC2 has not exercised her testamentary general power of appointment, the trustees shall distribute Trusts 8 and 11 to GGGC2's then living issue, per stripes, and if no such issue is then living, then to GGC1's issue, per stirpes.

Trusts 7, 8, 10, and 11 each provide for the same default dispositive provisions as Trusts 1, 2, 4, and 5, respectively. To the extent GGGC1 or GGGC2 dies leaving no children or issue of a deceased child, the trust estates pass in equal shares to the trusts established to GGC1's other children. If the trusts for the other children have terminated and there are no other children or issue of deceased children of GGC1, the trust estates of Trusts 7, 8, 10, and 11 will pass to Grandson's issue, and if none, the trust estates will pass one-half to University A and one-half to University B.

It is represented that the purpose of the merger is to retain the assets of Trusts 1 through 6 in further trust after the death of GGC1 and GGC2 and to appoint successor trustees for Trusts 7 through 12. Currently, Trusts 7 through 12 are not funded and it is represented that these trusts will remain unfunded until the mergers. It is represented that all of the current and remainder beneficiaries of Trusts 1 through 6 have consented to the proposed mergers.

Statute 1 provides that a trustee may declare one or more new trusts for the purpose of merging all, or a portion, of an existing trust or trusts with and into the new trust or trusts,

> whether or not created by the same trustor and whether or not funded prior to the merger, to be held and administered as a single trust if such a merger would not result in a material change in the beneficial interests of the trust beneficiaries, or any of them in the trust.
>
> Statute 2 provides that a trustee, without authorization by the court, may exercise powers conferred by the terms of the trust; and except as limited by the terms of the trust, any other powers conferred by this chapter.
>
> Statute 3 provides that whenever a trust (a transferor trust) is merged with and into another trust (the transferee trust) the separate existence of the transferor trust shall cease and the transferee trust shall possess all of the rights and privileges, and shall be subject to all of the obligations of, the transferor trust.

Note that Trusts 8 and 11 provided earlier termination than the original trusts but grant a general power to the beneficiary whose death would trigger termination. Thus, also they accelerate distribution to the remaindermen, they make that subject to a general power of appointment, thereby dimishing the remaindermen's beneficial interest.

After reviewing the regulations governing trusts grandfathered from GST, including Reg. § 26.2601-1(b)(4)(i)(E), Example (6), Letter Ruling 201711002 held:

> In the instant case, although initially administered in State 1, Trusts 1 through 6 have been administered in State 2 since the appointment of Trustee, who has its principal place of business in State 2. Therefore, State 2 law is applicable. The merger of Trusts 1 through 6 (Transferor Trusts) into Trusts 7 through 12 (Transferee Trusts), respectively, is permitted under State 2 law if such merger would not result in a material change in the beneficial interests of the trust beneficiaries. Statute 1. Statute 2 provides that a trustee may act under Statute 1 without authorization by the court. Statute 3 provides that, following the merger, the governing instruments of Transferee Trusts control the disposition of the property of their respective Transferor Trusts.
>
> During the lifetime of GGC1 and GGC2, the dispositive terms of the Transferor Trusts and their respective Transferee Trusts are the same. After the merger, Trusts 9 and 12 will terminate upon the death of the survivor of GGC1 and GGC2, Trusts 7 and 10 will terminate on the date of GGGC1's death, and Trusts 8 and 11 will terminate on the date of GGGC2's death. However, Trusts 7, 8, and 9, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust A was created, and Trusts 10, 11, and 12, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust B became irrevocable. In addition, GGGC1 is granted a general power of appointment over Trusts 7 and 10, which will cause Trusts 7 and 10 to be includible the gross estate of GGGC1 at her death under § 2041(a)(2). Further, GGGC1 will be treated as the transferor of the corpus of Trusts 7 and 10 for GST tax purposes under § 2652(a)(1). Similarly, GGGC2 is granted a general power of appointment over Trusts 8 and 11, which will cause Trusts 8 and Trust 11 to be includible in the gross estate of GGGC2 at her death under § 2041(a)(2). Further, GGGC2 will be treated as the transferor of the corpus of Trusts 8 and 11 for GST tax purposes under § 2652(a)(1).
>
> Accordingly, the terms of Trusts 7 through 12 will not extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute

> ownership, or power of alienation of an interest in property beyond the period provided for in the original trusts, Trust A and Trust B. Moreover, Trusts 7 through 12 will not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the trustee action.
>
> Therefore, based on the facts submitted and representations made, we conclude that upon the merger of Trust 1 into Trust 7, Trust 2 into Trust 8, Trust 3 into Trust 9, Trust 4 into Trust 10, Trust 5 into Trust 11 and Trust 6 into Trust 12, the Transferee Trusts (i.e. Trusts 7 through 12) will be exempt from GST tax under § 26.2601-1(b).

If a decanting constitutes a transfer from one taxpayer to another taxpayer, be sure to make a timely ESBT election.[2725]

II.J.18.d. Trust Commutations

Reg. § 1.1001-1(a), "General rule," begins with and then concludes with:

> Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained…. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010).

Code § 1001(e), "Certain term interests," provides:[2726]

> (1) *In general*. In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.
>
> (2) *Term interest in property defined*. For purposes of paragraph (1), the term "term interest in property" means -
>
> (A) a life interest in property,
>
> (B) an interest in property for a term of years, or
>
> (C) an income interest in a trust.

[2725] See Letter Ruling 201941006, described in the text accompanying fn 5616 in part III.A.3.e.ii.(a) Qualification as an ESBT.
[2726] In this part II.J.18.d, see text accompanying fn 2745 for additional explanation of Code § 1001(e).

(3) *Exception*. Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

In other words, under Code § 1001(e)(1), a person who sells a life interest in property, an interest in property for a term of years, or an income interest in a trust receives no basis with respect to the trust's assets and recognizes gain on the entire value. On the other hand, if all of the beneficiaries get together and simultaneously sell their interests in the trust to a third party, under Code § 1001(e)(3) they would be able to use basis. Also note that Code § 1001(e)(1) and regulations implementing it do not prevent basis frombeing allocated to remaindermen.

The legislative history for when Code § 1001(e) was first enacted in the Tax Reform Act of 1969 (P.L. 91-172), is as follows (excerpted from BNA):

House Committee Report

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6. Sales of life estates, etc. (sec. 516(a) of the bill and sec. 1001 of the code)

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called "uniform basis" rule is applied with the basis of the property divided between the life estate and the remainder. (As the life estate is used up each year, its basis is reduced, and the basis of the remainder interest is increased in the same amount—hence, the combined basis of the life estate and the remainder interest remains the same from year to year.)

The life tenant is not permitted to amortize his basis over the length of the life estate because this would reduce for tax purposes the

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amount of income he receives. However, where the life tenant sells his right to receive future income, his basis in the property may be used in reducing the gain he receives on the sale. In addition, such a life estate (or an estate for a term of years) is frequently treated by the courts as a capital asset, and any amount received upon its sale in excess of the adjusted basis of the life estate is treated as a capital gain. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above has the effect of allowing a large part, and in some cases, almost all of the income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income because he is treated as having a basis in the life estate when he sells it and, in addition, the purchaser of the life estate is not taxed on most of the income because he is allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. Your committee does not believe that income should be allowed to completely escape taxation by this means.

Explanation of provision.—Your committee's bill provides a new rule for determining the amount of gain or loss from the sale or other disposition of a life interest (or an interest for a term of years) in property or an income interest in a trust. In such a case, the bill provides that any portion of a taxpayer's adjusted basis determined under sections 1014 or 1015 of the code (dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust) is disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property.

Thus, where there is a sale or other disposition of a life (or term of years) interest in property, or an income interest in a trust—which was acquired by gift, bequest, inheritance, or by a transfer in trust—there is to be no cost or other basis to offset the proceeds received from the disposition. Accordingly, the person disposing of such an interest is to be required to treat as gain the entire amount he receives from the disposition of his interest, rather than only the excess of the amount received over his basis.

The bill, however, does not change present law in the situation where there is a sale or other disposition of a life or term of years interest in property (or an income interest in trust) which is a part of a transaction in which the entire fee interest is transferred to any person or persons. Thus, where a life tenant and remainderman simultaneously sell the entire fee interest in property in a single transaction, it is to be treated in the same manner as under existing law; the gain each receives is to be measured by the excess of the proceeds received on the disposition over the adjusted basis in the life estate. Your committee believes this exception is appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Supplemental Report

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SECTION 516. OTHER CHANGES IN CAPITAL GAINS TREATMENT

(a) Sales of life estates and term interests.—Subsection (a) of section 516 of the bill adds a new subsection (e) to section 1001 of the

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code (relating to determination of amount of and recognition of gain or loss).

General rule

Paragraph (1) of new section 1001(e) provides that, in determining the gain or loss from the sale or other disposition of a “term interest in property” (as defined in new section 1001(e) (2)), that portion of the adjusted basis of such interest which is determined under section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gifts and transfers in trust) is to be disregarded to the extent that such adjusted basis is a portion of the entire adjusted basis of the property. Under this provision, a person who sells a term interest in property, such as a life interest, to which new subsection (e) applies and the basis of which is an amount computed by apportioning the basis of such property between the life interest and the remainder interest, may not reduce the amount realized by his adjusted basis in such interest.

Term interest defined

Paragraph (2) of new section 1001(e) defines the term "term interest in property" as an interest which is: (A) a life interest in property, (B) an interest in property for a term of years, or (C) an income interest in a trust.

Exception

Paragraph (3) of new section 1001(e) provides that the rules stated in paragraph (1) of new section 1001(e) do not apply to a sale or other disposition which is a part of a transaction in which a fee interest is transferred to any person or persons. For example, new subsection (e) does not apply to a case in which a life tenant and a remainderman simultaneously sell the entire fee interest in property to a third party in a single transaction.

Example.—A devises Blackacre to B for life, with the remainder to C in fee simple. The fair market value of Blackacre at A's death is $10,000. B is considered to hold a life interest in property under new section 1001(e) (2) (A). B and C share the $10,000 basis determined pursuant to section 1014. Assume B and C each have a basis under section 1014 of $5,000 for their respective interests. If B sells his life interest in Blackacre to D for $20,000, B is treated as having gain of $20,000 since his $5,000 adjusted basis is disregarded under new section 1001(e)(1).

House Discussion

Congressional Record

(August 7, 1969)

[Page H7132]

Mr. HELSTOSKI * * * * *

23. Capital Gains. —Capital gain and loss treatment is revised in several respects. First, the alternative capital gains tax for individuals was repealed, with the result that in the case of those in the top tax brackets, the rates may rise to as much as 35 percent (or 32½ percent under the new rate structure provided by this bill); second, long-term capital losses of individuals are reduced by 50 percent before being available as an offset against ordinary income; third, the offset against ordinary income in the case of husbands and wives filing separate returns is limited to $500 for each or to the same aggregate amount as if they filed a joint return; fourth, the sale of papers by a person whose efforts created them, or by a person for whom they were produced, is to give rise to ordinary income; fifth, the holding period for capital gains is increased from 6 months to 12 months; sixth, employees' contributions to pension plans, when paid out as a part of a lump-sum distribution, is to be taxed as ordinary income; seventh, life interests are not to be accorded a cost basis when sold; eighth, casualty losses and gains are to be consolidated in determining whether they give rise to ordinary loss or to gain which is consolidated with other section 1231 gains or losses; and ninth, transfers and franchises

are not to be treated as giving rise to capital gains if the transferor retains significant rights.

House Action

Summary of H.R. 13270

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6. Sales of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

House solution.—The bill provides that the entire amount received on the sale or other disposition of a life (or term-of-years) interest in property, or an income interest in a trust (which was acquired by gift, bequest, inheritance, or by a transfer in trust), is to be-taxable, rather than only the excess of the amount received over the seller's basis for his interest. This provision applies to sales or other dispositions after July 25, 1969.

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The House bill, however, does not change present law where a life interest is disposed of as part of a single transaction in which the entire fee interest is transferred (e.g., where a life tenant and remainderman simultaneously join in a sale of the entire property interest) to any person or persons. In such a case, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the disposition over his adjusted basis in the property.

Argument For.—The present tax law has the effect of allowing a large part, and in some cases almost all, of the income from a life estate to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income he receives from the sale because he will usually have a tax basis equal to, or almost equal to, the sales price. This is regarded as particularly undesirable by those who view such transactions as an anticipatory assignment of income rather than as the sale of a property interest.

Argument Against.—A sale of a property interest is involved and therefore it is appropriate in measuring the amount of gain to reduce the proceeds by the amount of the life tenant's basis.

SENATE Finance Committee

Treasury Statements

Hon. Edwin S. Cohen

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Additional changes made by the bill include a provision that life interests received by gift, bequest or inheritance, are not accorded a tax basis when sold. Under the bill, all casualty gains and losses on capital assets and section 1231 property are consolidated for the purposes of determining whether they give rise to an ordinary loss or to a gain which is consolidated with other section 1231 gains and losses. Finally, the bill provides that transfers of franchises will not give rise to capital gain treatment if the transferor retains any significant rights in connection with the transfer.

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In all other respects, we support the capital gain and loss provisions of the bill.

Committee Decisions—Compilation

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Sales of Life Estates.—The Committee also adopted the provision of the House-passed tax bill which relates to the sales of life estates. In general, this provision provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property, or income interest in trust (whether acquired by gift, bequest, inheritance, or by a transfer in trust), is to be taxable without any reduction for the taxpayer's basis. Presently, only the excess of the amount received over the seller's basis is taxed. The Committee, however, did change the effective date for the provision. Under the Senate version, this provision would become effective as to sales or other dispositions after October 9, 1969 (the House bill would have applied with respect to sales or other distributions after July 25, 1969).

Summary of Bill as Reported by Committee

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8. Sales of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

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Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

Finance Committee decision.—The House bill and the committee amendments provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust), is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Neither version of the bill, however, changes present law where a life interest is disposed of as a part of a single transaction in which the entire fee interest is transferred to any other persons. This occurs, for example, where a life tenant and remainderman join in the sale of the entire property interest. In such a case the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his basis for his interest.

The House bill would apply to sales or other dispositions after July 25, 1969. The committee amendment moves this effective date up to October 9, 1969.

Committee Report

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8. Sales of Life Estates, etc. (sec. 516(a) of the bill and sec. 1001 of the code)

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called “uniform basis” rule is applied with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced, and the basis of the remainder interest is increased in the same amount—hence, the combined basis of the life estate and the remainder interest remains the same from year to year.

The life tenant is not permitted to amortize his basis over the length of the life estate and thereby reduce for tax purposes the amount of income he receives. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale.

The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above has the effect of allowing a large part, and in some cases, almost all of income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income to the extent of the basis which he is treated as having in the life estate when he sells it and, in addition the purchaser of the life estate is not taxed on most of the income because he is allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible

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loss. The committee agrees with the House that income should not be allowed to completely escape taxation by this means.

Explanation of provision.—The House bill and the committee amendments, in effect, generally provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Specifically, the bill provides that for purposes of determining the amount of gain or loss in such a case, any portion of a taxpayer's adjusted basis determined under the provisions dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust (secs. 1014 and 1015) is to be disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property. Thus, there is to be no basis to be offset against the proceeds received on a disposition of this type of interest, and, accordingly, the person disposing of the interest must treat the entire amount he receives from the disposition of his interest as a gain.

Neither version of the bill, however, changes present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. Thus, for example, where a life tenant and remainderman hold all of the interests in property which they simultaneously sell in a single transaction, the transaction is to be treated in the same manner as under existing law; that is, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate. The committee agrees with the House that this exception is appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Committee Report—Individual Views of Senator Albert Gore

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(3) Sales of life estates.—A fundamental rule of the tax laws is that a person cannot convert ordinary income into capital gain by transferring the right to receive the future income.

An exception to this basic rule has been permitted to develop in the case of a person who has the right to income for life from a trust or other property. Present rules permit such a person to sell his income interest and pay capital gains rates. This result is inconsistent with basic tax rules.

The House bill modified the present rule somewhat by providing that the total amount realized on the sale would be treated as capital gain; that is, there would be no reduction in the gain realized for the taxpayer's basis. This provision merely replaces one inconsistent rule with another.

The proper tax treatment of these transactions is to give the tax-payer the benefit of any basis, but to tax all gain as ordinary income under regular rules dealing with transfer of future rights to receive income. The Senate should adopt the proper rule as a substitute for the House provision.

Senate Action

Summary of Senate Amendments

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8. Sates of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

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Senate amendments.—Both versions of the bill, in effect, generally provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Neither version of the bill, however, changes present law in the situation where there is a sale or other disposition of a life (or term of years) interest property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly.

The Finance Committee amendments, make only one change in the House bill. They apply to sales or other dispositions after October 9, 1969. The House bill is effective with respect to sales or other dispositions made after July 25, 1969.

HOUSE-SENATE CONFERENCE

Conference Action

Conference Report

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6. Sales of life estates, etc. (sec. 1001 of the code)

The House bill provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in trust, if such interest was acquired by gift, bequest, inheritance, or a transfer in trust, is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

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The provision does not, however, change present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property or an income interest in trust where such sale is a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly.

The Senate amendment makes the provision applicable to sales or other dispositions after October 9, 1969, rather than with respect to sales or other dispositions made after July 25, 1969, as under the House bill.

The conference substitute (sec. 516(a) of the substitute and sec. 1001 of the code) follows the Senate amendment.

POST-ENACTMENT

Joint Committee General Explanation of The Tax Reform Act

[Page 174]

7. Sales of Life Estates, Etc. (sec. 516(a) of the Act and sec. 101 of the code)

Prior law.—When a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called “uniform basis” rule is applied with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced, and the basis of the remainder

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interest is increased in the same amount; hence, the combined basis of the life estate and the remainder interest remains the same from year to year.

The life tenant in this case is not permitted to amortize his basis over the period of the life estate and thereby reduce for tax purposes the amount of income he reports. However, under prior law, where the life tenant sold his right to receive future income, his basis in the property at the time of sale was used to reduce the gain he received on the sale. The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above had the effect of allowing a large part, and in some cases, almost all of the income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sold his interest. The life tenant was not taxed on the income to the extent of the basis which he was treated as having in the life estate when he sold it. In addition, the purchaser of the life estate was not taxed on most of the income because he was allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In some cases the seller's basis even exceeded the amount he received upon its sale, and, as a result, he was permitted to take a deductible loss.

Explanation of provision.—In general, the Act provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Specifically, the Act provides that for purposes of determining the amount of gain or loss in such a case, any portion of a taxpayer's adjusted basis determined under the provisions dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust (secs. 1014 and 1015) is to be disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property. Thus, in the type of situations considered here, there is no basis to be offset against the proceeds received on a disposition of this type of interest; and, accordingly, the person disposing of the interest must treat the entire amount he receives from the disposition of his interest as a gain.

> The Act does not, however, change present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. Thus, for example, where a life tenant and remainderman hold all of the interests in property which they simultaneously sell in a single transaction, the transaction is to be treated in the same manner as under existing law; that is, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate. This exception appeared appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Implementing this rule, Reg. § 1.1001-1(f), "Sale or other disposition of a term interest in property," which was adopted by T.D. 7142 (9/23/1971) without any explanation,[2727] provides:

> (1) *General rule*. Except as otherwise provided in paragraph (f)(3) of this section, for purposes of determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in paragraph (f)(2) of this section), a taxpayer shall not take into account that portion of the adjusted basis of such interest that is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010) to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in § 1.1014-5). Where a term interest in property is transferred to a corporation in connection with a transaction to which section 351 applies and the adjusted basis of the term interest:
>
> (i) Is determined pursuant to sections 1014, 1015, or 1022; and
>
> (ii) Is also a portion of the adjusted uniform basis of the entire property, a subsequent sale or other disposition of such term interest by the corporation will be subject to the provisions of section 1001(e) and this paragraph (f) to the extent that the basis of the term interest so sold or otherwise disposed of is determined by reference to its basis in the hands of the transferor as provided by section 362(a). See paragraph (f)(2) of this section for rules relating to the characterization of stock received by the transferor of a term interest in property in connection with a transaction to which section 351 applies.[2728] That portion of the adjusted uniform basis of the entire property that is assignable to such interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014-5. Thus, gain or loss realized from a sale or other disposition of a term interest in property shall be determined by comparing the

[2727] Proposed regulations were published June 24, 1971 at 36 F.R. 12018-12019. They did not include any explanation, either. Reg. § 1.1001-1(f)(3) does not differ from its proposed form; I have not compared the other provisions.

[2728] [My footnote:] Code § 351 is described in part II.M.2.a Initial Incorporation – Generally, which is the beginning of part II.M.2 Buying into or Forming a Corporation.

amount of the proceeds of such sale with that part of the adjusted basis of such interest that is not a portion of the adjusted uniform basis of the entire property.

(2) *Term interest defined*. For purposes of section 1001(e) and this paragraph, a "term interest in property" means -

(i) A life interest in property,

(ii) An interest in property for a term of years, or

(iii) An income interest in a trust.

Generally, subdivisions (i), (ii), and (iii) refer to an interest, present or future, in the income from property or the right to use property which will terminate or fail on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur. Such divisions do not refer to remainder or reversionary interests in the property itself or other interests in the property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest. A "term interest in property" also includes any property received upon a sale or other disposition of a life interest in property, an interest in property for a term of years, or an income interest in a trust by the original holder of such interest, but only to the extent that the adjusted basis of the property received is determined by reference to the adjusted basis of the term interest so transferred.

(3) *Exception*. Paragraph (1) of section 1001(e) and subparagraph (1) of this paragraph shall not apply to a sale or other disposition of a term interest in property as a part of a single transaction in which the entire interest in the property is transferred to a third person or to two or more other persons, including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common. See § 1.1014-5 for computation of gain or loss upon such a sale or other disposition where the property has been acquired from a decedent or by gift or transfer in trust.

(4) *Illustrations*. For examples illustrating the application of this paragraph, see paragraph (d) of § 1.1014-5.

Reg. § 1.1001-1(f)(3) requires a transfer "to a third person or to two or more other persons, including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common." This narrows Code § 1001(e)(3), which requires a transfer "to any person or persons."

Rev. Rul. 72-243 held:

> The Internal Revenue Service will follow the decision of the United States Court of Appeals for the Second Circuit in the case of *Beulah Eaton McAllister v. Commissioner*, 157 F.2d 235 (1946), certiorari denied, 330 U.S. 826 (1946), which held that the proceeds received by the life tenant of a testamentary trust in consideration for the transfer of her entire interest in the trust to the remainderman, are to be treated as an amount realized from the sale or exchange of a capital asset under section 1222 of the Internal Revenue Code of 1954.

Letter Ruling 8316135 involved the following facts:

> … a ruling is requested concerning the sale of certain interests in L to M, a foreign charity not subject to United States taxation.
>
> The information provided indicates that prior to his death on January 12, 1978, A, your father, created L. It is represented that L, a foreign organization, would be taxable as a trust if it conducted activities in the United States.
>
> Article 1 of the by-laws of L provides that during his life all rights to L's assets and net income thereof belong to A. Article 3 provides that upon A's death, B, A's wife, and you are to share L's net income as equal life beneficiaries. Articles 4 and 5 provide that upon the death of A and B, you or your children, if any, shall have all the rights to L's assets and income. Article 6 provides that the net income and assets of L shall be transferred to M in the event of the death of all other designated beneficiaries. Thus, M presently possesses a contingent remainder interest in L.
>
> You and B propose to sell your interests in L to M. It is represented that subsequent to this proposed sale, M will own the entire fee interest in L. It is also represented that your adjusted basis in your interests in L, and B's adjusted basis in her interest in L are determined pursuant to section 1014 of the Internal Revenue Code.

Letter Ruling 8316135 held:[2729]

> The exception in section 1001(e)(3) for the simultaneous sale of the life interest and the remainder interest in a single transaction is appropriate because "in this case the purchaser acquires a single entire interest in property and, therefore, he is not allowed to amortize the separate life interest". H.Rep. No. 91-413, 91st Cong., 1st Sess. 157 (1969), 1969-3 C.B. 200, 298.
>
> In the instant case subsequent to its purchase of your interest and B's interest in L, M will own the entire fee interest in L and, thus, would not be able to amortize any portion of this fee interest.
>
> Based upon the information submitted and representations made, we conclude as follows:
>
> 1. The amount of gain or loss you will recognize from your proposed sale of your interests in L will be measured by the difference between the amount realized on the sale of your life interest in L and your remainder interest in L and your adjusted basis in your life estate in L and your remainder interest in L.
>
> 2. The amount of gain or loss B will recognize from her proposed sale of her interest in L will be measured by the difference between the amount realized on the sale of her life interest in L and her adjusted basis in her life estate in L.

[2729] In this part II.J.18.d, see text preceding and accompanying fn 2744 to explain the comment in the legislative history referring to amortization.

Letter Ruling 8316135 did not cite Reg. § 1.1001-1(f)(3) (which was adopted in 1971) or compare it to Code § 1001(e)(3). Implicit in its ruling is that a contingent remainderman qualifies as a "third person." Also, only the life tenants were selling their interests; the ruling was silent as to how the contingent remainderman acquired the other remaindermen's interests.

Letter Ruling 8448059 involved the following facts:

> Your late wife died testate on August 6, 1982. At the time of her death, she owned a certain parcel of improved real estate (the "Real Estate"). Pursuant to her will and codicil the Real Estate was devised and bequeathed as follows: a life estate to you (as "Life Tenant") with the remainder in equal shares to each of A, B, C, and D. Presently, you and each of A, B, & C propose to sell your respective life estate and remainder interests to D…

Letter Ruling 8448059 reviewed Reg. § 1.1014-5 - especially Reg. § 1.1014-5(c) - Example (5)(b), and held:

> … if you consummate the proposed sale of your life estate to D, your section 1014 basis will be disregarded (you will have a zero basis for purposes of the sale); your taxable gain will be an amount equal to the sale price of the life estate; and D will have allowable amortization deductions against his basis in the life estate, which may be taken over the period of your remaining life expectancy. (Should D ever convert the property to business use, such deductions will be actually allowed.)

Letter Ruling 8948023 involved the following facts regarding charitable remainder unitrusts:

> A, B, C, and D wish to terminate the trusts. It is represented that M and N have agreed to the proposed termination. It is contemplated that one of the apartment buildings used to fund the Trusts will be sold and some of the proceeds therefrom will be distributed to M and N in satisfaction of their rights to the remainder interests in the Trusts. The balance of the cash and the other apartment building will be distributed to A,B, C, and D in satisfaction of their rights to the unitrusts amounts from the Trusts.

Letter Ruling 8948023 reviewed Reg. § 1.1014-5 – especially Reg. § 1.1014-5(c), Example (5), and held:

> In this case, A and B are selling their interests in Trust 1 to the remaindermen, M and N. C and D are selling their interests in Trust 2 and Trust 3, respectively, to the remainderman, N. Provided the cash and the property interests received by A, B, C, and D are distributed to each of them in accordance with their respective interests in the Trusts, the amount each realizes from the sale of his or her interest in the Trusts is the amount of cash and the fair market value of the property received by each.
>
> Pursuant to section 1001(e)(1) of the Code, the portion of the adjusted uniform basis assigned to the respective interests of A, B, C, and D in the Trusts is disregarded. The exception contained in section 1001(e)(3) is not applicable, because the entire interest in the Trusts' assets is not being sold, or otherwise disposed of, to a third party. A, B, C, and D have no basis in their respective interests in the Trusts.

Rev. Rul. 98-8, in addressing the gift tax consequences to the surviving spouse of the acquisition by the surviving spouse of the remainder interest in a trust subject to a QTIP election, recited the following facts:

> The decedent, D, died in 1993 survived by S, D's spouse. Under the terms of D's will, a trust (the QTIP Trust) was established under which S was to receive all of the trust income, payable at least annually, for S's life. On S's death, the remainder was to be distributed outright to C, D's adult child.
>
> S was not given a general power of appointment over the trust property.
>
> On the federal estate tax return filed for D's estate, the executor made an election under section 2056(b)(7) to treat the trust property as QTIP, and a marital deduction was allowed to D's estate for the value of the property passing from D to the QTIP Trust.
>
> Subsequently, S, C, and the trustee of the QTIP Trust entered into the following transaction: (1) S acquired C's remainder interest in the QTIP Trust; (2) S gave C a promissory note in the face amount of x dollars (the value of the remainder interest) for the remainder interest; (3) the trustee distributed all of the QTIP Trust assets (having a value of x + y dollars) to S; and (4) S thereupon paid x dollars from those assets to C in satisfaction of the promissory note.
>
> At the conclusion of the transaction, the QTIP Trust was terminated; S held QTIP Trust assets having a value of y dollars (which was equal to the value of S's life interest in the trust); and C held assets having a value of x dollars (which was equal to the value of the remainder interest in the trust). S contended that the transaction was not subject to gift tax because S received full and adequate consideration (the x dollar remainder interest in the QTIP Trust) in exchange for the x dollar promissory note given by S to C.

Inserting Code § 2519[2730] into the mix, Rev. Rul. 98-8 reasoned:

> The estate tax marital deduction provisions are intended to provide a special tax benefit that allows property to pass to the surviving spouse without the decedent's estate paying tax on its value. Tax is deferred on the transfer until the surviving spouse either dies or makes a lifetime disposition of the property. Under either circumstance, a transfer (estate or gift) tax is paid. *United States v. Stapf*, 375 U.S. 118, 128 (1963), 1964-1 (Part 1) C.B. 535, 537; *Estate of Clayton v. Commissioner*, 976 F.2d 1486, 1491 (5th Cir. 1992); *Estate of Letts v. Commissioner*, 109 T.C. 290, ___ (1997) ("It is a basic policy of the marital deduction that property that passes untaxed from a predeceasing spouse to a surviving spouse is included in the estate of the surviving spouse.")
>
> The statutory scheme of the QTIP provisions is consistent with this congressional intent. Thus, a marital deduction is allowed under section 2056(b)(7) for property passing from a decedent to a QTIP trust in which the surviving spouse possesses a lifetime income interest. Sections 2519 and 2044 act to defer the taxable event on the marital deduction

[2730] See part II.H.2.c QTIP Trusts - Code § 2519 Trap, which cites Rev. Rul. 98-8 at fn 1921. It also mentioned that Letter Ruling 199908033 asserted that the remaindermen's consent to terminating a QTIP trust such that the surviving spouse received all of the property without restriction, without receiving consideration for that consent, constitutes a gift of their remainder interest.

property only so long as the surviving spouse continues to hold the lifetime income interest.

Under section 2519, if a surviving spouse disposes of any part of the qualifying income interest, the spouse is treated as making a gift of the remainder interest in the underlying property (*i.e.*, all interests in the property other than the income interest). Correspondingly, under section 2511, the disposition of the income interest by the spouse is treated as a gift, to the extent the income interest is transferred to another for less than adequate consideration.

The term “disposition,” as used in section 2519, applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means. See H. Rep. No. 201, 97th Cong., 1st Sess. 161 (1981) that states:

The bill provides that property subject to a [QTIP election] will be subject to transfer taxes at the earlier of (1) the date on which the spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the spouse's death.

A commutation, which is a proportionate division of trust property between the life beneficiary and remainderman based on the respective values of their interests is, in the context of a QTIP trust, a taxable disposition by the spouse of the qualifying income interest, resulting in a gift under section 2519 of the value of the remainder interest. The commutation of the spouse's income interest in the QTIP trust is essentially a sale of the income interest by the spouse to the trustee (or the remainderman) in exchange for an amount equal to the value of the income interest. Sales and commutations are expressly characterized as dispositions in the applicable legislative history and regulations. Section 25.2519-1(g), Example 2 (illustrating that the sale by the spouse of the spouse's income interest to the trust remaindermen is a disposition of the income interest); section 25.2519-1(f) providing that “[T]he sale of qualified terminable interest property, followed by the payment to the donee-spouse of a portion of the proceeds equal to the value of the donee- spouse's income interest, is considered a disposition of the qualifying income interest”. See also, *Estate of Novotny v. Commissioner*, 93 T.C. 12 (1989), in which the surviving spouse and remainderman divided the sale proceeds of QTIP property proportionately on the basis of the respective values of their interests; the court indicated that the commutation constituted a disposition by the spouse of the income interest for purposes of section 2519 and was thus subject to gift tax.

There is little distinction between the sale and commutation transactions treated as dispositions in the regulations and the transaction presented here, where S acquired the remainder interest. In both cases, after the transaction the spouse's income interest in the trust is terminated and the spouse receives outright ownership of property having a net value equal to the value of the spouse's income interest. Similarly, the remainderman receives ownership of property equal in value to the remainder interest. Thus, the transaction in the instant case essentially effectuates a commutation of S's income interest in the trust, a transaction that is a disposition of S's income interest under section 2519. Therefore, under section 2519, S is regarded as making a gift of x dollars, the value of the remainder interest in the QTIP Trust. Section 25.2519-1(f).

This conclusion that S has made a gift is also supported by an additional analysis. S acquired an asset (the remainder interest in the QTIP Trust) that is already subject to inclusion in S's transfer tax base under section 2044. In analogous situations, the courts have recognized that the receipt of an asset that does not effectively increase the value of the recipient's gross estate does not constitute adequate consideration for purposes of the gift and estate tax. See *Commissioner v. Wemyss*, 324 U.S. 303, 307 (1945), 1945 C.B. 416, ("The section taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers which are withdrawn from the donor's estate.")

A companion case to *Commissioner v. Wemyss*, *Merrill v. Fahs*, 324 U.S. 308 (1945), 1945 C.B. 418, and the cases that preceded it, involved situations where A, an individual, transferred property to B, A's spouse (or future spouse), in exchange for B's relinquishment of marital rights in A's property. The Court held that B's relinquishment of the marital rights did not constitute adequate and full consideration for A's transfer because the assets subject to the marital rights were already includible in A's taxable estate. The property subject to dower and marital rights is clearly included in the gross estate of the property owner. Thus, to conclude that the relinquishment of dower and marital rights by the spouse of the property owner constituted adequate and full consideration for a transfer by the property owner for gift tax purposes would effectively subvert the legislative intent and statutory scheme of the gift tax provisions. *Merrill v. Fahs*, at 311-312. See also, *Commissioner v. Bristol*, 121 F.2d 129, 136 (1st Cir. 1941).

Likewise, in the present situation, property subject to the QTIP election was intended to be subject to either gift or estate tax. S's receipt of the remainder interest does not increase the value of S's taxable estate because that property is already subject to inclusion in S's taxable estate under section 2044. Rather, S's issuance of the note results in a depletion of S's taxable estate that is not offset by S's receipt of the remainder interest. Thus, for estate and gift tax purposes, S's receipt of the remainder interest cannot constitute adequate and full consideration under section 2512 for the promissory note transferred by S to C. As was the case in *Merrill v. Fahs*, any other result would subvert the legislative intent and statutory scheme underlying section 2056(b)(7). Therefore, under section 2511, S has made a gift to C equal to the value of the promissory note S gave to C.

In addition, a gift tax would be imposed under the above alternative rationales even if S acquired only a portion of C's remainder interest; *e.g.*, S acquired 60 percent of C's remainder interest. If, under applicable state law, such a transaction results in a partial termination of the trust, S would be treated as disposing of part of S's income interest in the trust, and the commutation analysis would apply. See, *e.g.*, Restatement (Second) of Trusts section 340(2) (1959). See also, section 25.2519-1(g), Example 4, (illustrating the estate and gift tax consequences of the disposition of a portion of the spouse's income interest). If the trust does not terminate, S would nonetheless be treated as making a transfer under sections 2511 and 2512 for less than adequate and full consideration to the extent of the value of the property or cash S transfers in exchange for the partial remainder interest.

Further, the conclusion of this revenue ruling would be the same if S transferred to C property or cash rather than the promissory note. The economic effect of the transaction is identical, regardless whether S uses S's own funds to finance the transaction or gives a promissory note and discharges the note using some of the QTIP Trust assets received in the transaction. Thus, the result is the same for transfer tax purposes.

Rev. Rul. 98-8 held:

If a surviving spouse acquires the remainder interest in a trust subject to a QTIP election under section 2056(b)(7) in connection with the transfer by the surviving spouse of property or cash to the holder of the remainder interest, the surviving spouse makes a gift both under section 2519 and sections 2511 and 2512. The amount of the gift is equal to the greater of (i) the value of the remainder interest (pursuant to section 2519), or (ii) the value of the property or cash transferred to the holder of the remainder interest (pursuant to sections 2511 and 2512).

Letter Ruling 200152018 held that the swap of a unitrust interest for an annuity interest was eligible for a charitable income tax deduction to the extent that the present value of the former exceeded the present value of the latter. It also held:

In the instant case, because Taxpayer's basis in his unitrust interest is in a trust, that basis is determined pursuant to section 1015. Thus, in determining Taxpayer's basis in his unitrust interest upon his transfer of the unitrust interest to the Academy in exchange for an annuity interest from the Academy, the portion of the adjusted uniform basis assigned to Taxpayer's unitrust interest will be disregarded pursuant to section 1001(e)(1). The exception to section 1001(e)(1) in section 1001(e)(3) is not applicable, because the remainder beneficiary is not receiving the entire interest in Trust in a single transaction.

As stated above, Taxpayer's unitrust interest is a capital asset. The annuity Taxpayer will receive from Academy will be nonassignable or will be assignable only to Academy, and Taxpayer will be the only annuitant. Accordingly, upon the transfer of his unitrust interest in the Trust to the Academy in exchange for an annuity payable by the Academy, Taxpayer will have long-term capital gain in the amount of the value of the annuity, reported as provided in example (8) of section 1.1011-2(c) of the regulations.

Letter Ruling 200314021 held:

Upon its termination, Trust proposes to distribute to Taxpayer as the income beneficiary and to Foundation as the remainder beneficiary lump sums equal to the present value of their respective interests on the date of termination. Trust represents that the values will be determined using the discount rate in effect under Section 7520 on the date of termination and using the methodology under Section 1.664-4 of the Income Tax Regulations for valuing interests in charitable remainder trusts…

… Taxpayer is selling his interest in Trust to the remainderman. Provided that the money and other property received by Taxpayer are distributed to Taxpayer in accordance with his interest in Trust, the amount Taxpayer will realize from the sale of his interest in Trust is the amount of money and the fair market value of the property received by Taxpayer.

Pursuant to Section 1001(e)(1), the portion of the adjusted uniform basis assigned to Taxpayer's interest in Trust is disregarded. The exception contained in Section 1001(e)(3) is not applicable, because the entire interest in Trust's assets is not being

> sold, or otherwise disposed of, to a third party. Accordingly, Taxpayer will be treated as though he has no basis in his interest in Trust and, therefore, Taxpayer will realize gain under Section 1001(c) in the amount received from the disposition of his interest in Trust.

Letter Ruling 200127023 was similar to Letter Ruling 200314021.

Letter Ruling 200833012, after acknowledging the rules in Code § 1001(e)(3) and Reg. § 1.1001-1(f)(3), held:

> Although the proposed transaction takes the form of a distribution of the present values of the respective interests of A, B, and the charities, in substance it is a sale of A and B's interest to the charities. The amount received by A and B as a result of the termination of Trust is an amount received from the sale or exchange of a capital asset. Under § 1015(b), A and B's basis in the life estate is a portion of the entire basis of the property, and the disposition of A and B's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party. Therefore, under § 1001(e), A and B's adjusted basis in their interest is disregarded. A and B's holding period in the life interest exceeds one year. Accordingly, under § 1222(3), the entire amount realized by A and B as a result of the early termination of Trust will be long-term capital gain.
>
> This ruling is conditioned on any assets distributed in-kind from Trust being distributed on a pro-rata basis between A, B, and the charities.

Similar holdings were in Letter Rulings 200827009, [2731] 200739004, [2732] 200733014, [2733] 200727013,[2734] 200648017,[2735] 200648016,[2736] 200441024,[2737] and 200403051.[2738]

[2731] "A is assigning A's income interest in Trust to Charity in exchange for a distribution equal to the present value of the unitrust income interest. Because the disposition of A's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party, the portion of the uniform adjusted basis assigned to A's income interest is disregarded under § 1001(e)."

[2732] "Accordingly, although the proposed transaction takes the form of a distribution of the present values of the respective interests of each Beneficiary and the Charity, it is in substance a sale of each Beneficiary's unitrust interest to the Charity, the remainder beneficiary. Because the disposition of each Beneficiary's interest is not part of a transaction in which the entire interest in the Trust is transferred to a third party, the adjusted basis in each Beneficiary's interest is disregarded under § 1001(e)(1) in determining gain realized by each Beneficiary."

[2733] "In the present case, although the proposed transaction takes the form of a distribution of the present values of the respective interests of Grantors and Charity, in substance it is a sale of Grantors' interest to Charity, the remainder interest holder. The amount received by Grantors as a result of the termination of Trust is an amount realized from the sale or exchange of a capital asset. Rev. Rul. 72-243. If, as represented by Grantors, Grantors' basis in the unitrust income interest is a portion of the entire basis of the property as determined under §1015(b), Grantors' adjusted basis in their interest is disregarded under § 1001(e) because the disposition is not part of a transaction in which the entire interest in Trust is transferred to a third party. Consequently, if Grantors' adjusted basis is disregarded under § 1001(e), the entire amount realized by Grantors as a result of the early termination of Trust will be gain to Grantors."

[2734] Similar to fn 2732.

[2735] "Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Granddaughter 1, A, B, C, D, and E, in substance it is a sale of Granddaughter 1, D and E's interests to A, B, and C, the remainder interest holders entitled to receive Trust 1 assets at termination under the terms of Trust 1. The amounts received by Granddaughter 1, D and E as a result of

Reg. § 1.1001-1(f)(4) refers to Reg. § 1.1014-5(d), which also effectuates the rest of Reg. § 1.1014-5. Let's go through that first:

Reg. § 1.1014-5(a), "Sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent," provides:

(1) Except as provided in paragraph (b) or (c) of this section with respect to the sale or other disposition after October 9, 1969, of a term interest in property, gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is assignable to the interest sold or otherwise disposed of. The adjusted uniform basis is the uniform basis of the entire property adjusted to the time of sale or other disposition of any such interest as required by sections 1016 and 1017. The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of part II, subchapter O, chapter 1 of the Code.

(2) Except as provided in paragraph (b) of this section, the proper measure of gain or loss resulting from a sale or other disposition of an interest in property acquired from a decedent is so much of the increase or decrease in the value of the entire property as is reflected in such sale or other disposition. Hence, in ascertaining the basis of a life interest, remainder interest, or other interest which is sold or otherwise disposed of, the uniform basis rule contemplates that proper adjustments will be made to reflect the change in relative value of the interests on account of the passage of time.

(3) The factors set forth in the tables contained in § 20.2031-7 or, for certain prior periods, § 20.2031-7A, of Part 20 of this chapter (Estate Tax Regulations) shall be used in the manner provided therein in determining the basis of the life interest, the remainder interest, or the term certain interest in the property on the date such interest is sold. The basis of the life interest, the remainder interest, or the term certain interest is computed by multiplying the uniform basis (adjusted to the time of the sale) by the appropriate factor. In the case of the sale of a life interest or a remainder interest, the factor used is the factor (adjusted where appropriate) which appears in the life interest or the remainder interest column of the table opposite the

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the termination of Trust 1 are amounts received from the sale or exchange of a capital asset. Rev. Rul. 72-243. Because Granddaughter 1's basis in the income interest of Trust 1 is a portion of the entire basis of the property under section 1015(b), and because the disposition of Granddaughter 1's term interest is not part of a transaction in which the entire interest in Trust 1 is transferred to a third party, Granddaughter 1's adjusted basis in Granddaughter 1's interest in Trust 1 is disregarded under section 1001(e)."

[2736] Completely or substantially the same as the quote in fn 2734.

[2737] "Although the proposed transaction takes the form of a distribution of the present values of the respective interests of X and Foundation, in substance it is a sale of X's interest to Foundation, the remainder interest holder. The amount received by X as a result of the termination of Trust is an amount received from the sale or exchange of a capital asset. Because X's basis in the unitrust income interest is a portion of the entire basis of the property under § 1015(b), and because the disposition of X's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party, X's adjusted basis in X's interest is disregarded under § 1001(e)."

[2738] Similar to fn 2732.

age (on the date of the sale) of the person at whose death the life interest will terminate. In the case of the sale of a term certain interest, the factor used is the factor (adjusted where appropriate) which appears in the term certain column of the table opposite the number of years remaining (on the date of sale) before the term certain interest will terminate.

Reg. § 1.1014-5(b), "Sale or other disposition of certain term interests," provides:

(1) *In general*. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010), that part of the adjusted uniform basis assignable under the rules of paragraph (a) of this section to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001-1(f).

(2) *Effective/applicability date*. The provisions of paragraph (b)(1) of this section relating to section 1022 are effective on and after January 19, 2017. For rules before January 19, 2017, see § 1.1014-5 as contained in 26 CFR part 1 revised as of April 1, 2016.

Explaining Reg. § 1.1014-5(c) below, T.D. 9729 (8/12/2015) said:

These final regulations provide a special rule for determining the basis in certain CRT term interests in transactions to which section 1001(e)(3) applies. Such transactions are those in which the sale or other disposition of the CRT term interest is part of a transaction in which all interests in the CRT are transferred. In these cases, these final regulations provide that the basis of a term interest of a taxable beneficiary is the portion of the adjusted uniform basis assignable to that interest reduced by the portion of the sum of the following amounts assignable to that interest: (1) the amount of undistributed net ordinary income described in section 664(b)(1);and (2) the amount of undistributed net capital gain described in section 664(b)(2). These final regulations do not affect the CRT's basis in its assets but rather are for the purpose of determining a taxable beneficiary's gain arising from a transaction described in section 1001(e)(3). The rules in these final regulations are limited in application to charitable remainder annuity trusts and charitable remainder unitrusts as defined in section 664.

Reg. § 1.1014-5(c), "Sale or other disposition of a term interest in a tax-exempt trust," provides:

(1) *In general*. In the case of any sale or other disposition by a taxable beneficiary of a term interest (as defined in §1. 1001-1(f)(2)) in a tax-exempt trust (as defined in paragraph (c)(2) of this section) to which section 1001(e)(3) applies, the taxable beneficiary's share of adjusted uniform basis, determined as of (and immediately before) the sale or disposition of that interest, is -

    (i) That part of the adjusted uniform basis assignable to the term interest of the taxable beneficiary under the rules of paragraph (a) of this section reduced, but not below zero, by

(ii) An amount determined by applying the same actuarial share applied in paragraph (c)(1)(i) of this section to the sum of -

(A) The trust's undistributed net ordinary income within the meaning of section 664(b)(1) and § 1.664-1(d)(1)(ii)(a)(1) for the current and prior taxable years of the trust, if any; and

(B) The trust's undistributed net capital gains within the meaning of section 664(b)(2) and §1.664-1(d)(1)(ii)(a)(2) for the current and prior taxable years of the trust, if any.

(2) *Tax-exempt trust defined*. For purposes of this section, the term tax-exempt trust means a charitable remainder annuity trust or a charitable remainder unitrust as defined in section 664.

(3) *Taxable beneficiary defined*. For purposes of this section, the term taxable beneficiary means any person other than an organization described in section 170(c) or exempt from taxation under section 501(a).

(4) *Effective/applicability date*. This paragraph (c) and paragraph (d) Example 7 and Example 8 of this section apply to sales and other dispositions of interests in tax-exempt trusts occurring on or after January 16, 2014, except for sales or dispositions occurring pursuant to a binding commitment entered into before January 16, 2014.

Reg. § 1.1014-5(d) provides examples for Reg. §§ 1.1001-1(f) and 1.1014-5, cross-referencing actuarial tables contained in the estate tax regulations:

Example (1). Securities worth $500,000 at the date of decedent's death on January 1, 1971 are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to § 20.2031-7A(c), the life estate factor for age 48, female, is found to be 0.77488 and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $387,440 ($500,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $112,560 ($500,000 × 0.22512). W sells her life interest to her nephew, A, on February 1, 1971, for $370,000, at which time W is still 48 years of age. Pursuant to section 1001(e), W realizes no loss; her gain is $370,000, the amount realized from the sale. A has a basis of $370,000 which he can recover by amortization deductions over W's life expectancy.

Example (2). The facts are the same as in example (1) except that W retains the life interest for 12 years, until she is 60 years of age, and then sells it to A on February 1, 1983, when the fair market value of the securities has increased to $650,000. By reference to § 20.2031-7A(c), the life estate factor for age 60, female, is found to be 0.63226 and the remainder factor for such age is found to be 0.36774. Therefore, the present value on February 1, 1983, of the portion of the uniform basis assigned to W's life interest is $316,130 ($500,000 × 0.63226) and the present value on that date of the portion of the uniform basis assigned to S's remainder interest is $183,870 ($500,000 × 0.36774). W sells her life interest for $410,969, that being the commuted value of her remaining life interest in the securities as appreciated ($650,000 × 0.63226). Pursuant to section 1001(e). W's gain is $410,969, the amount realized. A has a basis of $410,969 which he can recover by amortization deductions over W's life expectancy.

Example (3). Unimproved land having a fair market value of $18,800 at the date of the decedent's death on January 1, 1970, is devised to A, a male, for life, with remainder over to B, a female. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1971, A sells his life interest to S for $12,500. S is not related to A or B. At the time of the sale, A is 39 years of age. By reference to § 20.2031-7A(c), the life estate factor for age 39, male, is found to be 0.79854. Therefore, the present value of the portion of the uniform basis assigned to A's life interest is $15,012.55 ($18,800 × 0.79854). This portion is disregarded under section 1001(e). A realizes no loss; his gain is $12,500, the amount realized. S has a basis of $12,500 which he can recover by amortization deductions over A's life expectancy.

Example (4). The facts are the same as in example (3) except that on January 1, 1971, A and B jointly sell the entire property to S for $25,000 and divide the proceeds equally between them. A and B are not related, and there is no element of gift or compensation in the transaction. By reference to § 20.2031-7A(c), the remainder factor for age 39 male, is found to be 0.20146. Therefore, the present value of the uniform basis assigned to B's remainder interest is $3,787.45 ($18,800 × 0.20146). On the sale A realizes a loss of $2,512.55 ($15,012.55 less $12,500), the portion of the uniform basis assigned to his life interest not being disregarded by reason of section 1001(e)(3). B's gain on the sale is $8,712.55 ($12,500 less $3,787.45). S has a basis in the entire property of $25,000, no part of which, however, can be recovered by amortization deductions over A's life expectancy.

Example (5).

(a) Nondepreciable property having a fair market value of $54,000 at the date of decedent's death on January 1, 1971, is devised to her husband, H, for life and, after his death, to her daughter, D, for life, with remainder over to her grandson, G. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1973, H sells his life interest to D for $32,000. At the date of the sale, H is 62 years of age, and D is 45 years of age. By reference to § 20.2031-7A(c), the life estate factor for age 62, male, is found to be 0.52321. Therefore, the present value on January 1, 1973, of the portion of the adjusted uniform basis assigned to H's life interest is $28,253 ($54,000 × 0.52321). Pursuant to section 1001(e), H realizes no loss; his gain is $32,000, the amount realized from the sale. D has a basis of $32,000 which she can recover by amortization deductions over H's life expectancy.

(b) On January 1, 1976, D sells both life estates to G for $40,000. During each of the years 1973 through 1975, D is allowed a deduction for the amortization of H's life interest. At the date of the sale H is 65 years of age, and D is 48 years of age. For purposes of determining gain or loss on the sale by D, the portion of the adjusted uniform basis assigned to H's life interest and the portion assigned to D's life interest are not taken into account under section 1001(e). However, pursuant to § 1.1001-1(f)(1), D's cost basis in H's life interest, minus deductions for the amortization of such interest, is taken into account. On the sale, D realizes gain of $40,000 minus an amount which is equal to the $32,000 cost basis (for H's life estate) reduced by amortization deductions. G is entitled to amortize over H's life expectancy that part of the $40,000 cost which is attributable to H's life interest. That part of the $40,000 cost which is attributable to D's life interest is not amortizable by G until H dies.

Example (6). Securities worth $1,000,000 at the date of decedent's death on January 1, 1971, are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to § 20.2031-7A(c), the life estate factor for age 48, female, is found to be 0.77488, and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $774,880 ($1,000,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $225,120 ($1,000,000 × 0.22512). On February 1, 1971, W transfers her life interest to corporation X in exchange for all of the stock of X pursuant to a transaction in which no gain or loss is recognized by reason of section 351. On February 1, 1972, W sells all of her stock in X to S for $800,000. Pursuant to section 1001(e) and § 1.1001-1(f)(2), W realizes no loss; her gain is $800,000, the amount realized from the sale. On February 1, 1972, X sells to N for $900,000 the life interest transferred to it by W. Pursuant to section 1001(e) and § 1.1001-1(f)(1), X realizes no loss; its gain is $900,000, the amount realized from the sale. N has a basis of $900,000 which he can recover by amortization deductions over W's life expectancy.

Example (7).

(a) Grantor creates a charitable remainder unitrust (CRUT) on Date 1 in which Grantor retains a unitrust interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRUT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor's basis in the shares of X stock used to fund CRUT is $10x. On Date 2, CRUT sells the X stock for $100x. The $90x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRUT uses the $100x proceeds from its sale of the X stock to purchase Y stock. On Date 4, CRUT sells the Y stock for $110x. The $10x of gain on the sale of the Y stock is exempt from income tax under section 664(c)(1). On Date 5, CRUT uses the $110x proceeds from its sale of Y stock to buy Z stock. On Date 5, CRUT's basis in its assets is $110x and CRUT's total undistributed net capital gains are $100x.

(c) Later, when the fair market value of CRUT's assets is $150x and CRUT has no undistributed net ordinary income, Grantor and Charity sell all of their interests in CRUT to a third person. Grantor receives $100x for the retained unitrust interest, and Charity receives $50x for its interest. Because the entire interest in CRUT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained unitrust interest in CRUT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $100x, over Grantor's adjusted basis in the interest.

(d) Grantor's adjusted basis in the unitrust interest in CRUT is that portion of CRUT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014-5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRUT's adjusted uniform basis in its sole asset, the Z stock, is $110x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRUT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031-7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRUT's $0 of undistributed net ordinary income and its $100x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031-7 of this chapter to the full $110x of basis.

Example (8).

(a) Grantor creates a charitable remainder annuity trust (CRAT) on Date 1 in which Grantor retains an annuity interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRAT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor funds CRAT with shares of X stock having a basis of $50x. On Date 2, CRAT sells the X stock for $150x. The $100x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRAT distributes $10x to Grantor, and uses the remaining $140x of net proceeds from its sale of the X stock to purchase Y stock. Grantor treats the $10x distribution as capital gain, so that CRAT's remaining undistributed net capital gains amount described in section 664(b)(2) and § 1.664-1(d) is $90x.

(c) On Date 4, when the fair market value of CRAT's assets, which consist entirely of the Y stock, is still $140x, Grantor and Charity sell all of their interests in CRAT to a third person. Grantor receives $126x for the retained annuity interest, and Charity receives $14x for its remainder interest. Because the entire interest in CRAT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained annuity interest in CRAT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $126x, over Grantor's adjusted basis in that interest.

(d) Grantor's adjusted basis in the annuity interest in CRAT is that portion of CRAT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014-5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRAT's adjusted uniform basis in its sole asset, the Y stock, is $140x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRAT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031-7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRAT's $0 of undistributed net ordinary income and its $90x of undistributed net capital gains.

(e) In determining Charity’s share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031-7 of this chapter to determine its actuarial share of the full $140x of basis.

Letter Ruling 200027001 analyzed a settlement involving a QTIP trust. The surviving spouse was entitled to the income, and the “trustee is authorized, in the trustee's discretion, to pay or apply additional funds from the principal of the Marital Trust to provide for Spouse's reasonable maintenance, support, comfort and welfare as the trustee deems necessary or advisable.” The remainder would pass to or for the benefit of the decedent’s other family members. The surviving spouse argued with the trustee over distributions and investment strategy. A settlement agreement resolved some disputes over which property belonged to the decedent and which to the surviving spouse – and:

> The agreement also directs that the trustee of the QTIP Trust pay the amount of $y to Spouse in exchange for Spouse's release of her rights to any part of the principal of the QTIP Trust. The agreement further provides that Spouse will sell her income interest in the QTIP Trust to [the remaindermen] for cash or other property valued at $z. The consideration will be paid proportionately in accordance with the respective interests of [the remaindermen] in the remainder of the QTIP Trust.
>
> The purchase price of the qualifying income interest in the QTIP Trust, $z, is equal to the actuarial value of Spouse's income interest as of Date 3, determined under section 20.2031-7 of the Estate Tax Regulations, based on the value of the corpus of the QTIP Trust as of Date 3. Until the sale of Spouse's interest in the QTIP Trust is completed, the QTIP Trust will continue to pay the income therefrom to Spouse according to the terms of the trust. However, income earned after Date 3 and paid to Spouse will reduce the purchase price, dollar-for-dollar. The settlement agreement recognizes that federal gift taxes will be imposed, as a result of the sale of Spouse's qualifying income interest in the QTIP Trust, under section 2519. The agreement confirms Spouse's right to recover such taxes from the persons who will receive the QTIP property, pursuant to section 2207A of the Internal Revenue Code. The settlement agreement, however, places a ceiling on Spouse's right of recovery. The settlement agreement provides that the QTIP Trust will terminate upon completion of the sale of Spouse's qualifying income interest, and the corpus will be distributed [to the remaindermen]…. The settlement agreement is contingent on court approval, which has been obtained by the parties, and favorable rulings from the Internal Revenue Service.

The surviving spouse asked the IRS to rule that any post-Date 3 income that reduced purchase price would constitute sale proceeds, making it taxable as capital gain rather than ordinary income, but the IRS declined to recharacterize the income:

> When a taxpayer receives a lump sum in exchange for the taxpayer's right to receive future income from property that does not represent a conversion of a capital investment, the taxpayer cannot characterize the transaction as a sale of property. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). The conversion of income already received by a beneficiary of an estate into principal was not permitted as part of a compromise agreement of a wife's claim against her deceased husband's will. *Lemle v. United States*, 579 F.2d 185 (2d Cir. 1978). This is especially the case in the present situation in which Spouse will already have received the payments from the trust at the time the sale of the income interest is consummated, and Spouse will be entitled to keep the payments whether or not the sale is consummated.

> The fact that the amount that will be paid for the income interest will be reduced by the amount of income that is paid by the QTIP Trust to Spouse after Date 3 and before the sale is made final does not change our conclusion.

As to taxing gain on sale, the IRS ruled:

> The sale of Spouse's interest in the principal of the QTIP Trust by Spouse constitutes a taxable sale for income tax purposes. Any gain or loss on the sale of Spouse's interest in the principal of the trust would be recognized under section 1001. The gain would be long-term capital gain, since the Decedent died on Date 1. Since section 1001(e) applies to income interests in trust, but not rights to principal, Spouse's basis in her interest in trust principal would not be disregarded.

As to gift tax consequences, the IRS reasoned and ruled:

> Section 2519 provides that any disposition of all or a part of a qualifying income interest for life in property for which an election had been made under section 2056(b)(7) is treated as the transfer of all interests in the property other than the qualifying income interest.
>
> Section 25.2519-1(c)(1) provides that the amount treated as a transfer under section 2519 upon a disposition of all or part of a qualifying income interest for life in QTIP property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under section 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. (The gift tax consequences of the disposition of the qualifying income interest are determined separately under section 2511 as discussed above in #5). [Ruling 5 said no gift assuming that "the sale is one made in the ordinary course of business, in that it is bona fide, at arm's length, and free from any donative intent."]
>
> Section 25.2511-2(a) provides that the gift tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.
>
> Section 2207A(b) provides that if a gift tax is paid with respect to any person because of a transfer made by that person under section 2519, then that person shall be entitled to recover the tax attributable to the transfer from the person receiving the property.
>
> Rev. Rul. 75-72, 1975-1 C.B. 110, holds that gift tax imposed on a transfer that is paid by the donee may be deducted from the value of the transferred property in determining the amount of the gift, if it is established that the payment of the tax by the donee or from the property is a condition of the transfer. If, at the time of the transfer, the gift is made subject to the condition that the gift tax is to be paid by the donee or out of the transferred property, then the donor receives consideration for the transfer in the amount of the gift tax to be paid by the donee. Thus, under section 2512(b), the value of the gift is measured by the fair market value of the property passing from the donor minus the amount of the gift tax to be paid by the donee.

> Rev. Rul. 81-223, 1981-2 C.B. 189, holds that, in determining the amount of the gift, the gift tax liability assumed by the donee may be deducted from the value of the transferred property, if the payment of the tax by the donee is a condition of the transfer. The donor's available unified credit must be used to reduce the tax liability that the donee has assumed to the extent the unified credit is available.
>
> In a case like the present one, where the gift tax will be imposed as a result of a transfer under section 2519, section 2207A(b) statutorily shifts the tax burden, but not the liability, for paying the gift tax to the donee. In reimbursing the donor for the gift tax paid pursuant to the statute, the donee provides consideration for the gift. The donee's payment inures to the benefit of the donor because it reimburses the donor for gift tax that the donor was liable for and would otherwise be required to pay out of the donor's own funds.
>
> Accordingly, we conclude that upon Spouse's disposition of Spouse's qualifying income interest for life, Spouse will be treated as making a gift under section 2519. Under section 2519, the gift tax will be imposed upon on the entire value of the QTIP Trust as of the date that the actual transfer occurs, reduced by: 1) the value of the Spouse's qualifying income interest for life on the transfer date; 2) the amount paid to Spouse for the release of her interest in trust principal under the settlement agreement; and 3) the amount of gift tax that Spouse recovers under section 2207A(b) as limited under the terms of the settlement agreement.

Note that the gift tax liability would be included in the surviving spouse's estate if she died within three years of making the deemed gift.[2739] Ordinarily, that's a wash, in that the cash used to pay the gift tax is out of the estate, so the inclusion and reduction in cash offset each other. With a net gift, however, the tax reimbursement eliminates the reduction in cash, so this type of settlement does increase the surviving spouse's estate if she dies within that three-year period. Of course, given that the remaindermen were not beneficiaries of her estate, she would rather have the cash, minus any estate tax, than not have the cash.

In Letter Ruling 200231011, Grandson was the income beneficiary and charities were the remaindermen.[2740] When disputes about administration arose (again), the parties entered into the following agreement, subject to court approval:

[2739] Code § 2035(b), "Inclusion of gift tax on gifts made during 3 years before decedent's death," provides:

> The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.

[2740] The background was:

> Decedent died testate on Date 1, prior to 1985. Pursuant to the terms of Decedent's will, a residuary testamentary trust (Trust), was established primarily for the benefit of Decedent's grandson (Grandson). Under the terms of Trust, Grandson was to receive S dollars each year during his life. Upon Grandson's death, the corpus was to be distributed as follows: 1/3 to Charity 1; 1/3 to Charity 2; 1/6 to Charity 3; and 1/6 to Charity 4. The terms of Trust provide that no beneficiary could alienate or encumber his/her interest in the income or principal and no beneficiary's interest was subject to claims of his/her creditors prior to distribution. Trust was funded with stock of Corporation with an approximate value of X dollars.
>
> In Year 1, pursuant to a court order, the investments of Trust were restructured and the dispositive provisions of Trust were modified to provide for annual income distributions to

> Under the terms of the proposed agreement, corpus of Trust in excess of Z dollars will be distributed immediately to Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion of their current remainder interests in Trust. Upon distribution, the charities' interest in Trust will terminate. The remaining assets of Trust will continue in trust for the benefit of Grandson. Grandson will receive at least annually an amount equal to seven percent of the net fair market value of the property held in Trust determined on a specified date in each calendar year. In addition, the trustee may distribute income or principal to provide adequately for the reasonable support of Grandson. On Grandson's death, the remaining corpus will be distributed pursuant to Grandson's exercise of a testamentary general power to appoint the remaining corpus to anyone, including his estate or the creditors of his estate. Any portion of the Trust not effectively appointed by the exercise this power will be distributed to Grandson's surviving descendants free of trust.

After reviewing *Cottage Savings*, Letter Ruling 200231011 held:

> The application of § 1001(a) to trust interests is illustrated by two cases. In *Evans v. Commissioner*, 30 T.C. 798 (1958), the taxpayer exchanged her income interest in a trust for an annuity, and the court concluded that this was a realization event. Taxpayer's income interest had entitled her to dividends paid by a corporation, the stock of which was owned by the trust. She transferred the income interest to her husband, who agreed in exchange to pay her fixed sums annually until her death.
>
> A contrary result was reached in *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969). In that case, the taxpayer exchanged an interest in a trust for a right to specified annual payments from the remainderman of the trust, and the court held that taxpayer did not as a result dispose of her trust interest. After the transaction, taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The court distinguished the transaction from that found to be a realization event in Evans: “the amount of Mrs. Evans' interest in the trust was not definitive. It varied with the dividend return on the trust stock. She exchanged this `uncertainty' for definitely ascertained yearly payments from her husband.” 419 F.2d. at 1003.
>
> The proposed trust modification in this case more closely resembles the situation in *Evans* than that in *Silverstein* and should be considered a realization event. Grandson currently is entitled to trust income, subject to a floor and a ceiling. Under the proposed order, he would become entitled to annual payments of seven percent of the fair market value of the trust property, with the trustee having some discretion to make additional payments under certain circumstances. Even assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the

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Grandson in accordance with a Performance Chart. The order required distributions to Grandson of an amount equal to the lesser of the maximum income amount set forth in the Performance Chart or the actual net income of Trust. Grandson was guaranteed a minimum income amount even if actual Trust income was less than that minimum income amount. Thus, if earnings of Trust are sufficient, Grandson would receive more than the minimum stated amounts each accounting period. In addition, Charities 1, 2, 3 and 4 received a lump sum payment. Upon Grandson's death, the remaining corpus was to be distributed to the Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion as set forth in Trust.

guaranteed minimum annual payments required by the Performance Chart. He also would not be limited by the Performance Chart's maximum annual payment ceilings. Finally, payments would be determined without regard to trust income. In short, Grandson's interest in the modified trust would entail legal entitlements different from those he currently possesses. This conclusion is reinforced by adding to the Taxpayer's current entitlement the general power of appointment over any trust corpus, even though this was a necessary element in a favorable GST conclusion set forth in issue #3, below.

> Pursuant to § 1001(e)(1), the portion of the adjusted uniform basis assigned to Grandson's interest in Trust is disregarded. The exception contained in § 1001(e)(3) is not applicable because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party. Accordingly, for purposes of this transaction, Grandson has no basis in his interest in Trust. Therefore, the amount of gain Grandson realizes under § 1001(c) is the amount Grandson realized from the disposition of his assets in Trust. The gain realized by Grandson from the disposition of his interest will be long term capital gain. See Rev. Rul. 72-243, 1972-1 C.B. 233, providing that a sale of an income interest in a trust is a sale of a capital asset within the meaning of §§ 1221 and 1222.

Note that this ruling was issued before Reg. § 1.1001-1(h) was issued in its current form.[2741]

In Letter Ruling 201932001, lifetime distributions were as follows:

> On Date 1, a date prior to September 25, 1985, Settlor created an irrevocable trust, Trust, for the benefit of Son. The material purpose of Trust was to ensure that Son receive an income stream for his support. Under the terms of the Trust agreement, the trustees are required to distribute all of the net income of Trust to Son, and, upon his death, distribute the remainder to his issue, per stirpes. The Trust agreement does not authorize any distributions of principal during Son's life. Son has four living adult children (Current Remaindermen) and eight living grandchildren, four of whom are adults (Successor Remaindermen). None of Son's descendants has a predeceased child with living issue. Son and Bank are currently serving as co-trustees of Trust.

A court-approved agreement authorized the trustees to value the trust’s assets, determine the appropriate distributions to be made upon the trust’s termination under the agreement and terminate the trust. Upon the termination, the trustees would distribute, on a pro rata or in-kind basis, as the trustees in their sole discretion determine, all of the trust’s assets to income beneficiary, immediate remaindermen and successor remaindermen according to their actuarial interests calculated as of the termination date. The ruling held that the termination did not blow the trust’s grandfathering from GST tax and did not constitute a gift. However, the income tax rulings were not so innocuous:[2742]

> Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Son, the Current Remaindermen, and the Successor Remaindermen, in substance it is a sale of Son’s and the Successor Remaindermen’s interests to the Current Remaindermen. Rev. Rul. 69-486.

[2741] Reg. § 1.1001-1(h) is reproduced in fn 2709 in this part II.J.18.

[2742] I have heard that this ruling was procured by David Handler and that the income tax consequences, although adverse, were relatively small in that particular case.

> The amounts received by Son as a result of the termination of Trust are amounts received from the sale or exchange of a capital asset to the Current Remaindermen. Rev. Rul. 72-243. Because Son's basis in the income interest of Trust is a portion of the entire basis of the property under § 1015(b), and because the disposition of Son's term interests is not part of a transaction in which the entire interest in Trust is transferred to a third party, Son's adjusted basis in Son's interest in Trust is disregarded under § 1001(e). Son's holding period in the life interests in Trust exceeds one year. Accordingly, based on the facts submitted and representations made, the entire amount realized by Son as a result of the early termination of Trust will be long-term capital gain under § 1222(3).
>
> Similarly, the amounts received by the Successor Remaindermen as a result of the termination of Trust are amounts received from the sale or exchange of a capital asset to the Current Remaindermen. *Cf. Helvering v. Gambrill*, 313 U.S. 11, 15 (1941), 1941-1 C.B. 364 (The phrase "property held by the taxpayer" under a prior law holding period rule relating to capital gains and losses includes not only full ownership, but also any interest owned whether vested, contingent, or conditional). The Successor Remaindermen's holding period in their interests in Trust also exceeds one year.
>
> Accordingly, under § 1222(3), the gain determined under § 1001(a) by the Successor Remaindermen as a result of the early termination of Trust will be long-term capital gain.
>
> In addition, to the extent that a Current Remainderman exchanges property, including property deemed received from Trust, for the interests of Son and the Successor Remaindermen, the Current Remainderman will recognize gain or loss on the property exchanged. Accordingly, based on the facts submitted and representations made, for purposes of determining gain or loss, the amount realized by each Current Remainderman on the exchange of property for Trust interests held by Son and the Successor Remaindermen will be equal to amount of cash and fair market value of the trust interests received in exchange for the transferred assets. Section 1.1001-1(a) and Rev. Rul. 69-486.

Letter Ruling 201932001 is further analyzed in part II.J.18.e Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations.

Reg. § 1.1014-8 governs the basis of a remainder interest, but it has not been updated for various changes in the law.

Code § 167(e), "Certain term interests not depreciable," provides:

> (1) *In general*. No depreciation deduction shall be allowed under this section (and no depreciation or amortization deduction shall be allowed under any other provision of this subtitle) to the taxpayer for any term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person.
>
> (2) *Coordination with other provisions*.
>
> > (A) *Section 273*. This subsection shall not apply to any term interest to which section 273 applies.

(B) *Section 305(e)*. This subsection shall not apply to the holder of the dividend rights which were separated from any stripped preferred stock to which section 305(e)(1) applies.

(3) *Basis adjustments*. If, but for this subsection, a depreciation or amortization deduction would be allowable to the taxpayer with respect to any term interest in property—

(A) the taxpayer's basis in such property shall be reduced by any depreciation or amortization deductions disallowed under this subsection, and

(B) the basis of the remainder interest in such property shall be increased by the amount of such disallowed deductions (properly adjusted for any depreciation deductions allowable under subsection (d) to the taxpayer).

(4) *Special rules*.

(A) *Denial of increase in basis of remainderman*. No increase in the basis of the remainder interest shall be made under paragraph (3)(B) for any disallowed deductions attributable to periods during which the term interest was held—

(i) by an organization exempt from tax under this subtitle, or

(ii) by a nonresident alien individual or foreign corporation but only if income from the term interest is not effectively connected with the conduct of a trade or business in the United States.

(B) *Coordination with subsection (d)*. If, but for this subsection, a depreciation or amortization deduction would be allowable to any person with respect to any term interest in property, the principles of subsection (d) shall apply to such person with respect to such term interest.

(5) *Definitions*. For purposes of this subsection—

(A) *Term interest in property*. The term “term interest in property” has the meaning given such term by section 1001(e)(2).

(B) *Related person*. The term “related person” means any person bearing a relationship to the taxpayer described in subsection (b) or (e) of section 267.

(6) *Regulations*. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations preventing avoidance of this subsection through cross-ownership arrangements or otherwise.

Code § 267 is described in part II.G.4.l.iv Code § 267 Disallowance of Related-Party Deductions or Losses.

Code § 273, “Holders of life or terminable interest,” provides:

Amounts paid under the laws of a State, the District of Columbia, a possession of the United States, or a foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time.

The committee reports for Code § 167(e) (P L. 101-239, 12/19/89) explain:[2743]

House Explanation

Present Law.

The purchaser of a term interest in property is, for income tax purposes, entitled to amortize the cost of the interest over its expected life. The purchaser of a remainder interest in property generally does not include currently in income increases in the value of the interest.

On the other hand, a person who divides an interest in property into two parts cannot create an amortizable asset where none previously existed. Thus, a person who retains a term interest in property while transferring the remainder in that property cannot amortize the cost of the term interest.[1]

[1] See, *e.g.*, *Lomas Santa Fe, Inc. v. Commissioner*, 74 T.C. 662, 682-83 (1980); *United States v. Georgia R.R. & Banking Co.*, 348 F.2d 278, 288-89 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966).

Explanation of Provision.

No depreciation or amortization deduction is allowed for a term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person. The provision does not affect a depreciation deduction which is not attributable to a term of years of life estate. Thus, the owner of a term interest in a building cannot amortize the term interest but may claim the depreciation deduction with respect to the underlying building allowed under present law.

The taxpayer's basis in a term interest is reduced by the deductions disallowed by the provision, and the remainderman's basis in the remainder is increased by those deductions. In the joint purchase described in the above example, the child's basis in the preferred stock would be increased in each of the six years by $72.61, the amount of the amortization deduction denied to the parent by reason of the provision.

A term interest in property is a life interest in property, an interest in property for a term of years, or an income interest in a trust. A related person is any person bearing a relationship to the taxpayer described in section 267(b) or 267(e). In determining whether persons are related, the constructive ownership rules of section 267(c) apply.

The Secretary of the Treasury shall prescribe such regulations as may be necessary to carry out the purposes of the provision, including regulations preventing avoidance of the provision through cross-ownership arrangements or otherwise. Such regulations shall

[2743] Excerpted from RIA Checkpoint, USTR, "COMREP ¶1671.004 Disallowance of Depreciation for Certain Term Interests."

prevent avoidance of the provision by one family owning a term interest in one property and a remainder interest in a second property, while another family owns a remainder interest in the first property, and a term interest in the second property. Such regulations would also prevent avoidance through the joint purchases of interests in substantially similar property. For example, a parent could not avoid the provision by purchasing a life interest in stock of a corporation while a child purchases a remainder interest in other stock of the same corporation.

The committee does not intend to change the taxation of transactions in which the remainderman is taxed on his accretion in wealth. Thus, for example, the provision does not affect the taxation of a stripped bond under section 1286 or transactions in which the lessor is imputed income under section 467(f).

Effective Date.

The provision applies to life or terminable interests acquired or created after July 27, 1989, in taxable years ending after such date.

Conference Report

Conference Agreement.

The conference agreement follows the House bill, with the following modifications. First, the remainderman's basis in the remainder is not increased for any disallowed deductions attributable to periods during which the term interest was held by (1) an organization exempt from tax under subtitle A of the Code or (2) a nonresident alien individual or foreign corporation (but only if income from the term interest is not effectively connected with the conduct of a trade or business in the United States).

Second, the holder of an interest in property for a term of years whose amortization deduction would be allowed but for the provision is permitted a depreciation deduction computed as if he were absolute owner of the property. Thus, the provision does not allow such a depreciation deduction to a person whose amortization deduction is disallowed under present law.

Third, the increase in the remainderman's basis in his interest is reduced by any depreciation allowable to the term holder with respect to the underlying property.

Fourth, the provision does not apply to any term interest to which section 273 applies.

In addition, the conferees intend that the remainderman's basis in the property is increased only if the term holder's amortization deduction would be allowed but for the provision.

The confereees intend no inference regarding the divisibility of property for tax purposes under present law. Nor do they intend any inference regarding the character of income or gain from property so divided.

Rev. Rul. 62-132 held:

> The Internal Revenue Service will follow the decision of the United States Court of Appeals for the Sixth Circuit in *Commissioner v. William N. Fry, Jr., et al.*, 283 Fed.(2d) 869 (1960), and the decision of the United States Court of Appeals for the Seventh Circuit in *Laird Bell v. Harrison, et al.*, 212 Fed.(2d) 253 (1954).
>
> These cases hold that a remainderman of a trust, the corpus of which consists of corporate stock, who purchases the interest of a life beneficiary of the trust, is entitled to recover his cost through amortization over the period of the beneficiary's life expectancy, by ratable annual deductions.
>
> The Service had argued that the purchased life interest became merged with the remainder interest, with the result that the cost of the purchased life interest could be recouped only at the time of the sale or other disposition of the stock.
>
> The Service noted that the transactions in these cases appeared to be bona fide and without a tax avoidance motive. These cases will be followed in the disposition of other cases in which the facts are substantially the same.
>
> [1] Based on Technical Information Release 392, dated July 16, 1962.

Thus:

- Under Code § 273, the holder of a life or terminable interest acquired by gift, bequest, or inheritance cannot amortize its basis. Note that none of these events is a purchase, so Code § 273 does not affect purchases.
- Under Code § 167(e)(1), a taxpayer holding a term interest cannot amortize that interest when the remainder interest is held (directly or indirectly) by a related person.
- Rev. Rul. 62-132 allows the purchaser of a term interest to amortize it if Code § 167(e)(1) does not apply.
- The seller of a term interest cannot apply basis against sale proceeds unless the overly narrow Reg. § Reg. § 1.1001-1(f)(3), which requires a transfer "to a third person or to two or more other persons," applies.

In *Garvey v. U.S.*, 369 F.Supp.2d 1328 (D. Kan. 2005), in 1987 Mr. and Mrs. Garvey bought life interests and 1983 irrevocable trusts they had created bought remainder interests in interests in a newly formed partnership. A 1986 letter from their investment advisor described the plan:

> Although the initial objective was to determine if there is an opportunity by utilization of split purchases of property to transmit it to subsequent generations with no transfer tax costs, an additional objective emerged and that is as a method of extracting corporate [or partnership] assets to others without the imposition of either a dividend or capital gains tax.
>
> "It" is the split purchase of assets from unrelated parties with the older generation buying a life estate or a term of years and the younger generation purchasing the remainder interest with the cost allocated based on the actuarial tables….

> Upon the expiration of the term interest, the entire property, including accumulated capital gains or less accumulated capital losses, passes to the remainderman free of income, gift and estate taxes….
>
> The practical limiting factor is the availability of funds by the persons or entities to purchase the remainder interest. Simultaneous gifts of funds for the acquisition of the interest contains an element of risk in collapsing the transaction into one of being a "retained" interest rather than a "purchased" interest, in which case the favorable estate tax results do not occur. Gifts separated by time or gifts by the spouse of the purchaser of the term interest would work.
>
> There is no gift tax imposed in any point in time in the described transaction because there is no gift, *i.e.*, each party is paying the market value of its interest as determined the actuarial tables.
>
> While the term interest is in effect its holder may amortize and deduct for Federal income tax purposes the aliquot portion of the cost of the term interest although the property may otherwise be nondepreciable, *e.g.*, securities or land.
>
> Properly drafted, any capital gains realized during the time of the term interest are subjected to tax but not to either the holder of the term interest or the remainderman, but to an "implied trust" which constitutes a separate taxpayer, presumably at lower rates, with the tax paid from the proceeds of the transaction giving rise to the gain, and with the remainder of the proceeds being retained with the income therefrom, being paid to the holder of the term interest.
>
> Upon expiration of the term interest there is no income tax liability to the remainderman upon receipt of the property, with the only unfavorable factor being the remainderman's tax basis in the entire property is only his cost of the remainder interest.
>
> In a life estate, of course, upon death of the life tenant there would be no estate tax, which is a potentially significant advantage of utilizing a life estate other than a term interest.

From 1987-1996, deductions from amortizing their life estate in the partnership were $1,496,073, and their share of the partnership income was $898,475. When the IRS disallowed the amortization deductions, the taxpayers paid and sued for a refund. The *Garvey* court explained:

> Plaintiffs assert that they are entitled to a refund of the income taxes in issue because during the periods here pertinent, relevant tax law provided that to recover plaintiffs' tax basis in the assets they contributed to Joy, an amortization deduction was available over the limited life of their interests in the partnership. They contend that the law provided that an asset (in this case a partnership interest) owned for a limited term with other related parties qualified for an amortization deduction. (See, *e.g.*, *Richard Hansen Land, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2869 (1993)). Plaintiffs cite the general rule that a taxpayer who purchases a term interest in property which is used in a trade or business, or held for the production of income, is entitled to deduct ratably the cost of that interest over its expected life.[1] See, *e.g.*, Tres. Reg., 1.1014-5(c), Examples 1, 2 and 3; Rev. Rul. 62-132, 1962-2 CB 73; *Early v Commissioner*, 445 F.2nd, 166, 169 (5th Cir. 969 [sic, 1971]); *Manufacturers Hanover Trust Co., v Commissioner*,

431 F.2nd 664 (2nd Cir. 1970). Plaintiffs contend that the general rule applies to their investment in Joy.

> [1] An exception to the general rule is sec. 167(e) (as amended and in effect currently), which prohibits a taxpayer from amortizing a term interest where a related person holds the remainder interest. This section, however, applies only to term interests acquired or created after July 27, 1989. Since plaintiffs' term interests were created before that date, sec. 167(e) is inapplicable to the present case.

> Defendant counters that plaintiffs formed Joy as the result of an integrated plan by which the plaintiffs transferred assets to other partners, who in turn then joined with the plaintiffs in the formation of the partnership. Defendant cites an exception to the general rule which occurs where a taxpayer, without additional investment, divides nondepreciable property into two parts, one of them being a term interest. In such a situation, amortization deductions are not allowable. See, *e.g.*, *Lomas Santa Fe, Inc. v. Commissioner*, 693 F.2nd 71 (9th Cir. 1982); *United States v Georgia R.R. & Banking Co.*, (348 F.2nd 278 (5th Cir. 1965)). Defendant contends that the exception to the general rule applies because the formation of Joy was the culmination of singular steps in an agreed-upon plan, and thus the steps can be amalgamated and treated as part of a single transaction. See, *e.g.*, *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Kornfeld v. Commissioner*, 137 F.3rd, 1231 (10th Cir. 1998).

After reviewing *Gordon v. Commissioner*, 85 T.C. 309 (1985)[2744] and *CGF Industries, Inc. v. Commissioner*, 77 T.C.M. (CCH) 1405 (1999), the court decided that the trusts were old and

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[2744] *Gordon* applied a step transaction theory to disallow the amortization, but only after commenting at 322-323:

> It is clear that a taxpayer may deduct ratably his or her cost basis in a purchased term, including a life, interest.[6] *Early v. Commissioner*, 445 F.2d 166, 169 (5th Cir. 1971), *revg.* on another ground 52 T.C. 560 (1969); *Manufacturers Hanover Trust Co. v. Commissioner*, 431 F.2d 664 (2d Cir. 1970), *affg*. a Memorandum Opinion of this Court; *Gist v. United States*, 296 F.Supp. 526, 528 (S.D. Cal. 1968), *affd*. 423 F.2d 1118 (9th Cir. 1970); *Frank MacBoyle Lewis Trust B v. Commissioner*, 83 T.C. 246, 253 n. 10 (1984); *Elrick v. Commissioner*, 56 T.C. 903, 909 (1971), *revd*. on another ground 485 F.2d 1049 (D.C. Cir. 1973); see also secs. 167(h), 62(6).[7] This is true even where the property underlying the purchased term interest is itself nondepreciable. See, *e.g.*, *Early v. Commissioner*, *supra* ; *Manufacturers Hanover Trust Co. v. Commissioner*, *supra*; *Elrick v. Commissioner*, *supra*. However, it is also clear that where a taxpayer, without additional investment, divides nondepreciable property into two parts, one of them being a term interest, amortization deductions are not allowable. *United States v. Georgia Railroad & Banking Co.*, 348 F.2d 278, 286-289 (5th Cir. 1965); *Lomas Santa Fe, Inc. v. Commissioner*, 74 T.C. 662, 681-684 (1980), *affd*. 693 F.2d 71 (9th Cir. 1982).
>
> [6] There has been considerable controversy as to whether these ratable deductions are allowable as depreciation or amortization under sec. 167 or as amortization under secs. 162 and 212. See *Sohosky v. Commissioner*, 57 T.C. 403, 409 & n. 4 (1971), *affd*. 473 F.2d 810 (8th Cir. 1973); *Early v. Commissioner*, 52 T.C. 560, 568-572 (1969) (Tannenwald, J., dissenting). For purposes of discussion herein, we simply acknowledge that ratable deductions of some nature are allowable to a purchaser of a term interest in property either used in a trade or business or held for the production of income. For convenience, we have used the term "amortization" in discussing the transactions involved herein. In this connection, we note that respondent, in his opening brief, dropped the argument that petitioners' deductions are not allowable due to sec. 265(1), which disallows deductions allocable to tax-exempt income. See

cold and that the taxpayers were entitled to deduct amortization of their life interests, based on these conclusions of law:

> During the relevant period, taxpayers who acquired a term interest in intangible property were allowed to amortize or depreciate the cost of the interest, even when the underlying property itself was not depreciable. Internal Revenue Code § 167(a) and Tres. Reg. 1.167(a)-3 and the cases cited herein. Thus, it was legal for Mr. and Mrs. Garvey to amortize or depreciate life estate interests in Joy.
>
> On the other hand, a taxpayer was prohibited from amortizing or depreciating the cost of term interest where, without additional investment, the taxpayer divides the nondepreciable asset into two parts, one of which is the term interest. Based upon the facts and the applicable law cited herein, the court concludes that plaintiffs have met their burden to establish that this did not occur.

Thus, on or before July 27, 1989, taxpayers could amortize life interests they purchased, if they did not themselves at the same time create the remainder interest. This rule explains Letter Ruling 8316135,[2745] which allowed the seller of a life estate to deduct basis in the life estate because the buyer was unable to amortize the life estate, given that the purchase there caused all interests in the trust to merge. So, let's take a fresh look at elements of Code § 1001(e):[2746]

- Code § 1001(e)(1), (2) disallow applying basis when selling a term interest.
- Code § 1001(e)(3) provides that this disallowance does "not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons."

According to Letter Ruling 8316135,[2747] the Code § 1001(e)(3) exception is designed simply to make sure that the buyer cannot amortize the life estate. However, now that Code § 167(e) disallows that amortization when related parties hold the remainder interest, Code § 1001(e)(1) should not apply to those situations. Rather, Code § 1001(e)(1) should apply only when unrelated parties hold the remainder interest. Unfortunately, the lack of coordination between Code § 167(e) and Code § 1001(e)(1) is puzzling and may undermine this reasoning.

Suppose the life tenant buys out the remaindermen. The remaindermen can use basis in such a sale. Economically, the parties are in the same position as if the remaindermen had bought out the life tenant, but with different tax results. For example, suppose the life estate is worth $400,000 and the remainder is worth $600,000, for a total of $1 million. The life tenant borrows $600,000 to buy out the remaindermen. The life tenant now has the full $1 million trust, sells enough liquid assets to repay the $600,000 loan, and has $400,000 left. Economically, that doesn't differ from the life tenant being bought out for $400,000. But the tax result is very

> *Manufacturers Hanover Trust Co. v. Commissioner*, 431 F.2d 664 (2d Cir. 1970), *affg.* a Memorandum Opinion of this Court.
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> [7] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

[2745] In this part II.J.18.d, see text accompanying fn 2728 for details on Letter Ruling 8316135. For application of the remaining analysis of this part II.J.18.d, see fn 2753 in part II.J.18.f Commutation vs Mere Division.
[2746] Code § 1001(e) is reproduced in this part II.J.18.d in the text accompanying fn 2725.
[2747] In this part II.J.18.d, see text accompanying fn 2728.

different, and so are the logistics. If the trust has only marketable securities, the transaction may be very do-able. However, if the trust holds illiquid assets, the logistics may be quite difficult; the life tenant buys out the remaindermen and then turns around and sells the illiquid assets to them, the IRS might argue that the substance was a sale of the life estate.

II.J.18.e. Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations

"Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations," LISI Estate Planning Newsletter #2753 (October 9, 2019) at http://www.leimbergservices.com, reviews this ruling and its companions (201932001 to 201932010), discussing the income tax ruling.[2748] Except as otherwise indicated in footnotes, the rest of this part II.J.18.e is a direct quote, with Ed's permission.

It's the third ruling on the income tax effect that should wake up practitioners, especially when considering how the gain in ruling #3 was ultimately calculated. It is dangerous trap for commutations and potentially other variations of early trust terminations – and potentially avoidable. If the IRS is correct in its rulings, the cure of terminating a trust early will often be much worse than the perceived disease of continuing it….

Therefore, G2 must pay long-term capital gains tax on the entire amount of his interest (importantly, with **no amount of basis permitted to offset gain, discussed below**), whereas G4 pays long-term capital gains tax on the amount they receive minus their share of the trust's basis as determined actuarially under the uniform basis rules. The impact on G3 is a bit confusing in the ruling, but apparently G3 only pays tax to the extent of the unrealized appreciation triggered on amounts going to G2 and G4 for their share.[2] The sole consolation is that G3 does not have to pay any tax on their share of assets received until they are later sold. In total though, this still creates a huge income tax event, *potentially worse than if the trustees had sold all of the appreciated assets*, with G2's estate being dramatically increased by the amount received net of tax even though he didn't need the income! This is a heavy price to pay to get out of a trust, like cutting off an arm to cure the itch from a mosquito bite.

> [2] This is basically Kenan gain (*Kenan v. Comm.*, 114 F.2d 217 (2d Cir. 1940)), also addressed in Treas. Reg. 1.661(a)-2(f). If G3 has an obligation to pay G2 $5 million and G4 $1 million, and distributes $6 million of property with a basis of $4 million to them, $2 million of gain is triggered to G3 on transfer, no different than if you owed someone $1000 and gave them appreciated assets in kind to pay the debt. Correspondingly, G2 and G4 would have a new FMV/Cost basis.

There are no dollar amounts in the various PLRs of course, but with a 35+ year old trust, there had to have been substantial appreciation. Let's imagine the trust corpus in these PLRs is $20 million, with $5 million basis and the actuarial value of G2's interest is $8 million and G3's interest is $11 million and G4's interest is $1 million (G4's interest should be relatively small, since they would only receive anything if their parent predeceases their grandparent).[3] The $5 million of basis would be divided under the uniform basis rules as $2 million, $2.75 million and $250,000 respectively. G2 pays long term capital gains tax (20% + 3.8% + potentially state) on $8 million (G2 cannot use his share of $2 million basis)! G4 pays long term capital gains tax on $1 million, but is permitted to use their $250,000 share of uniform basis to offset gain, incurring $750,000 of long-term capital gain.

[2748] Ed used dashes between the year and week of each PLR. I eliminated them.

[3] It is not a dynastic trust and pays outright at G2/Son's death to G3. For examples of such actuarial divisions under the uniform basis rules, see examples under Treas. Reg. § 1.1014-5, with various actuarial tables at Treas. Reg. § 20.2031-7 and IRS Pub. 1457, or your favorite financial planning software.

As a deemed *buyer* rather than a seller, G3 does not pay tax on receiving their share, but this transaction does trigger tax to G3 on the $9 million of assets going to G2 and G4 to "buy out" their share, minus the $2.25 million of basis attributed to those assets ($9 million - $2.25 million = $6.75 million net long-term capital gain, assuming that those assets have been held for more than one year, which may not necessarily be the case for all of them). Thus, the total gain triggered among the family is $11.5 million ($8 million + $750,000 +$6.75 million). If we assume a 30% tax rate including state income tax on this $11.5 million of gain, that's a **$3.45 million price tag to terminate the trusts** that could have largely been avoided by waiting until son's death, or releasing an interest or amending the trust or taking another path that would not cause such a tremendous income taxable event.

By way of quick contrast, let's say there was a market downturn after funding and the basis was $30 million instead of $5 million, but all other facts the same as in our above hypothetical. *G2 would still incur $8 million of long-term capital gains and $12 million of basis would be wiped off the face of the Earth.* G4 and G3 would have a long-term capital loss, but it would probably be denied them under related party rules.[4] Thus, the spectre of a large capital gains event is present even if done immediately after death, even if the trust is entirely funded in cash.

[4] IRC §267.

Effect on Later Estate Inclusion/Basis Step Up at Son (G2)'s Death

The immediate income tax disaster is not the only negative to the commutation. If son (G2) did not otherwise have a taxable estate, he could have been granted a formula testamentary power of appointment to increase some if not all of the basis at his death.

If son *did* have a taxable estate, which is perhaps more likely based on the stipulated fact in the PLRs that son didn't need the income, the effect of the commutation is even worse, since the settlement adds his entire share (minus beaucoup taxes) to his estate to later be taxed at 40% again at his death when it otherwise would have passed to them without any estate or GST tax!

"Now I am Become §1001(e), the Destroyer of Basis"[5]

As for the unique ruling on the destruction of G2's basis, it is a function of IRC § 1001(e)(1), which deems the sale of a trust income interest to have a *zero basis*.[6] There is an exception to this rule when the sale is part of a transaction in which the entire interest in property is transferred to any person or persons.[7] The Congressional intent of this provision was to prevent basis shifting abuse by letting remainderman continue to gradually increase their basis over time while the purchaser of an income interest still has a cost basis when a trust is not terminated.[8]

[5] A cheap reference to J. Robert Oppenheimer's quote of the Bhagavad Gita after the first successful test of nuclear bomb in New Mexico, "Now I am become Death, the destroyer of worlds.

[6] [quoting Code § 1001(e)(1)]

[7] [quoting Code § 1001(e)(13]

[8] See page 174-175 of the Joint Committee Explanation.

Arguably, since the trust will be completely terminated, this is part of a transaction "in which the entire interest in property is transferred to any person or persons" as required by IRC §1001(e)(3). The abusive situation and rationale in passing IRC §1001(e) is simply not present when the trust is terminated as it would be in a commutation.

Unfortunately, commutations do not fit into the wording of the statute well. Beneficiaries in a commutation are not transferring property to another in the traditional sense as much as transmuting it into a different form. Treasury regulations go beyond the code, moreover, and require a sale to a third party.[9] It seems extremely absurd to have completely different income tax treatment when parties transfer their interests to a straw man who will simply give them back the value of their interests in kind exactly as a commutation would (as the regulation appears to require). It's been a maxim for centuries of Anglo-American jurisprudence that the law does not require a futile act.[10]

[9] [quoting Reg. § 1.1001-1(f)(3)]

[10] *Lex non cogit ad inutilia*, for those readers who prefer to speak in Latin. For an example of this maxim quoted in the context of tax law, see this IRS CCM.

That said, in planning mode one should not pick a fight with the IRS armed only with common sense, especially with a regulation seemingly requiring one to abandon it. There are many PLRs ruling that a commutation does not come under the IRC § 1001(e)(3) exception, so it's best to simply play along with the charade.

If the agreement were instead to eliminate the spendthrift clause so that each party could sell all their trust interests to another party (basically allowing the new owner to terminate the trust under merger of interest doctrine), then upon joint sale the application of the IRC § 1001(e)(3) exception and compliance with Treas. Reg. § 1.1001-1(f) would be clear; G2 could use his share of uniform basis to reduce his tax upon sale, just as G3 and G4 do.

Can the Disappearing Basis Be Preserved?

Although it's relatively rare, when taxpayers purchase a trust interest, they are permitted to depreciate the cost of this purchase.[11] By being deemed to have purchased G2 and G4 shares, we'd love to think that G3 is therefore deemed to receive this basis somehow. Normally a buyer receives cost basis for what they paid for an asset.[12] Here, the IRS deems G3 to have "in substance" purchased them. Does G3 get basis for this? Probably not, since G3 did not actually pay anything. The IRS gave no indication of this in the rulings. That said, some believe that the disappearing basis should be preserved for G3 to eventually unlock on later sale of assets. I am skeptical. More likely, it is completely obliterated and G3 will probably only have a pro rata carry over basis in their remaining assets.

[11] See, *e.g.*, Treas. Reg. § 1.1014-5(d), Examples 1, 2, 3 and 5. To quote the committee reports on why Congress passed IRC § 1001(e): "The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it."

[12] Treas. Reg. § 1.1012-1(a).

Is a Commutation Always a Sale, Exchange or Other Disposition?

But is a commutation (early termination) even a sale or exchange or "other disposition" at all? Generally, distributions on trust terminations are not sales or exchanges triggering income tax.[13] That an early termination ordered by a court is a sale/exchange subject to IRC §1001 is not obvious – the parties will only receive their own pro-rata share of the trust.

[13] *Pierson v. Comm.*, 253 F.2d 928 (3rd Cir. 1958). IRC § 643(e) generally provides that distributions in kind from a trust receive a carryover basis unless gain is triggered otherwise, such as *Kenan* gain to satisfy a pecuniary obligation, or unless a trustee makes an election to trigger gain under (e)(3).[2749]

The IRS in these PLRs assumes that a commutation is a sale by referencing a revenue ruling that concerns non-pro rata distributions: [Ed then quotes the IRS' analysis from above]

The IRS may have a very good argument that a commutation agreed to by the parties is a sale or exchange under § 1001, since all the parties are receiving substantially different property interests as a result of the transaction. But Rev. Rul. 69-486 cited above is very dubious authority for that conclusion. In that Revenue Ruling, the trustee had no authority to make non-pro rata distributions and the two beneficiaries agreed between them as to the distribution and it was deemed to be a sale between them, no different than had they exchanged the different assets between each other.

By contrast, most trusts nowadays have authority under the instrument to make non-pro rata distributions, and if they don't, most state laws, such as UTC §816, now grant such authority,[15] and if state law does not grant such authority, the wide equitable powers granted to state courts under state law probably provide such authority, as has been previously acknowledged by the IRS in prior rulings. This PLR did not involve some rogue non-judicial settlement agreement contrary to state law. A court commuted the trust pursuant to state law and there was no allegation to the contrary. Thus, it's hard to see how Rev. Rul. 69-486 even comes close to applying. In fact, the natural corollary to Rev. Rul. 69-486 should be that a pro rata distribution in kind does ***not*** constitute a sale or exchange.

[15] UTC § 816(22) authorizes the trustee to "on distribution of trust property or the division or termination of a trust, make distributions in divided or undivided interests, allocate particular assets in proportionate or disproportionate shares, value the trust property for those purposes, and adjust for resulting differences in valuation." The UTC's comments to this section include: "Paragraph (22) *authorizes a trustee to make non-pro-rata distributions and allocate particular assets in proportionate or disproportionate shares. This power provides needed flexibility and lessens the risk that a non-pro-rata distribution will be treated as a taxable sale*."

Thus, the paragraph discussing non-pro rata distributions is a *red herring*. There is no indication that the parties proposed anything but a pro rata distribution and if there were pro rata distributions, this would not have changed the IRS conclusions in this PLR one iota. Even if the

[2749] [My footnote:] For Code § 643(e)(3), see text accompanying fns 2560-2564 in part II.J.8.d.i Distribution in Kind - Generally.

trust corpus were invested entirely in cash stored under the trustee's mattress, the IRS would have found that the son (G2) incurred a large capital gain equal to the value of his interest.

The more important, and dangerous, paragraph is the second one quoted above. To the IRS, it's a sale or exchange *in substance*, regardless of what authority was granted under the instrument or state law. More intriguing is the equally dubious conclusion that it's only a sale by two of the three parties. Why is this commutation in substance a sale by G2 and G4, and not G3? The IRS offers no rationale or logic for this conclusion (other than Rev. Rul. 69-486 which is inapplicable). Any student of logic could just as easily conclude that G3 and G4 are selling their shares to G2 or that G2 and G3 are selling their shares to G4 (or other permutations). Each group of beneficiaries is getting different property, not just two groups out of three as the IRS summarily concludes.

If a court-ordered commutation is a sale or exchange, it's not hard to imagine many other situations involving trust terminations to be *in substance* an exchange. *E.g.*, an agreed distribution of the trust assets to an income beneficiary followed by a gift to the remaindermen of their commuted value would probably be treated no differently, since that could *in substance* be a sale and exchange, even if the form of the transaction was a lawful distribution of corpus pursuant to the trustee's authority, followed by a gift.

The IRS has approved divisions of trusts in prior PLRs and concluded that to the extent the division was pro rata there was no taxable exchange, but to the extent the division was non-pro rata there would be deemed an exchange.[16]

[16] In PLR 200038014, the IRS acknowledged this when it found that a bifurcation of a trust into separate trusts via court order did not trigger capital gain, except to the extent the funding was non-pro rata:

"Neither the Will nor State law grants the Trustee power to make non-pro rata distributions from Trust 2. However, the court before which the petition seeking permission to divide Trust 2 is pending is a court of general jurisdiction in State with equity jurisdiction, and the court has the power to divide Trust 2 on a non-pro rata basis. ***The present case is distinguishable from Rev. Rul. 69-486 to the extent that assets of Trust 2 are divided on a pro rata basis.*** Thus, the proposed transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries. Further, to the extent that the assets are divided on a pro rata basis the distribution of the assets to the Separate Trusts will not be viewed as a pro rata distribution followed by an exchange of assets and will not give rise to a realization event as described in Rev. Rul. 69-486. As discussed above, to the extent that the assets are divided on a non-pro rata basis, the transaction will be treated in accordance with Rev. Rul. 69-486. Therefore, to the extent that the division of Trust 2 assets among the Separate Trusts is made on a pro rata basis, the division will not be considered a sale, exchange, or other disposition of property and will not cause Trust 2, the Separate Trusts, or any of the Income Beneficiaries to realize gain or loss under § 1001 and the division of Trust 2 into the Separate Trusts will not cause Trust 2, the Separate Trusts, or any of the Income Beneficiaries to realize income under § 61 or gain or loss under § 1001." Page 7 of ruling.

The PLRs did not address whether the commutation may be a tax-free *severance*. Treas. Reg. § 1.1001-1(h) provides that a severance is not an exchange if state statute or the governing instrument authorizes it and any non-pro-rata distributions. The regulation does not define "severance," however. Commutations seem to go beyond the common understanding of a severance, which implies continuation of multiple trusts.

Despite their citation to dubious authority, the IRS probably has the better argument on there being a taxable disposition. The parties bargained for and will receive fundamentally different interests in property (exchanging a trust interest for direct property interest), which is the core of IRC §1001 as discussed in the seminal Supreme Court case of *Cottage Savings*.[17] The IRS has so ruled many times before (see below).

[17] *Cottage Savings Assn. v. Comm.*, 499 US 554 (1991). In Cottage Savings, the Supreme Court held that mortgage loans made to different obligors and secured by different homes embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged participation interests in different loans. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is material to the Code so long as their respective possessors *enjoy legal entitlements that are different in kind or extent*.

But then, if we are primarily examining whether the parties in these ten PLRs are receiving materially different legal entitlements, which they clearly are, *why is it that G3 did not have to recognize any gain on its share?* There is no logic to this, other than that's the [sic] way the IRS has long construed such commutations in prior PLRs. I could find no citable authority on this artificial sale to G3 idea.

Does Beneficiary Involvement or Procurement Matter?

Many readers will wonder how the IRS or court would rule if, instead of the parties agreeing to divide the trust and handing the court and IRS an agreement to be blessed, the trustees had sought and the court ordered a commutation *without such an explicit agreement among the beneficiaries*. There is no clear answer from the PLR, but this would probably make no difference whatsoever. For gift tax purposes, it should, because gift tax generally requires a voluntary action on behalf of the donor.[18] Dispositions, however, do not – just ask anyone who has ever held stock in a company that went through a taxable merger or acquisition.

[18] For a discussion of gift and estate and income tax ramifications of amendments and settlements and why unilateral trustee actions such as decanting or court petitions may be treated differently for gift tax purposes than non-judicial or court actions involving beneficiary acquiescence, see Morrow, Edwin P., *The Optimal Basis Increase and Income Tax Efficiency Trust: Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (Or: Why You'll Learn to Love the Delaware Tax Trap)*, pages 132-156. Available at SSRN: https://ssrn.com/abstract=2436964, which is an update of the Optimal Basis Increase Trust, LISI Estate Planning Newsletter #2080 (March 20, 2013).

Earlier PLRs Concerning Commutations, Including CRT Commutation PLRs

This isn't the first PLR concerning commutations that found a taxable exchange. PLRs 200209007 and 200209008 also involved a commutation, but only a partial one. The trust beneficiary whose lifetime interest was commuted was deemed to have sold their interest, which would be a capital gain, with zero basis, just as in these recent PLRs. The other beneficiaries got off scot free without the IRS finding any sale or exchange of their interest because their interest in trust essentially continued with only minor modifications.

Similarly, in PLR 200231011, the trustee and the beneficiaries had agreed that the income beneficiary would receive (i) a 7% annual unitrust payment from the trust, (ii) principal from the trust in the discretion of the trustee and (iii) a testamentary general power of appointment over the remaining trust property, while the charitable remaindermen would receive an immediate payment based on the value of their remainder interest and be thereafter removed (*i.e.* commuted). The IRS ruled that the transaction was in effect a sale or disposition under IRC § 1001(a), with the zero-basis rule applying to the sale of the son's interest, similar to the PLRs discussed in this article, even though the son's interest in trust continued in different form.[19]

[19] PLR 200231011.

There are several rulings in which the IRS deemed commutations of charitable remainder trusts (CRTs) to be sales/exchanges (by the income beneficiary to remaindermen) triggering IRC § 1001. There are compelling reasons for the IRS to have applied the zero basis rules in this manner to curb abuse in the tax-exempt context.[20] Treasury eventually issued regulations in this area to prevent such manipulations so that undistributed income and gains inside the CRT reduce the lead income beneficiary's basis even upon sale to a third party.[21]

[20] See IRS Notice 2008-99, Rev. Proc. 2008-3 where the IRS placed these on a "transaction of interest" list before Treasury issued new regulations. See Rev. Proc. 2015-3, § 3.01(68). It's abusive because if not curbed, a taxpayer could contribute a zero basis property worth $10 million, the CRT sells the property tax-free and has a basis of $10 million and if the lead income beneficiary could use their share of uniform basis in selling their interest to a third party utilizing the IRC § 1001(e)(3) exception, it would be completely evading tax on the gain.

[21] See Treas. Reg. § 1.1014-5(c) and (d), Examples 7 and 8. This is a logical way to curb such abuse, because by reducing the basis by the gains never taxed, the taxpayer is denied "free basis". The appreciation is ultimately taxed.

But the legitimate public policy rationale to prevent tax evasion shut down by those CRT sale regulations does not exist for commutations of ordinary irrevocable trusts that are not tax exempt. Arguably, the polar opposite of tax evasion occurs under the zero-basis rule when such a trust is terminated without the § 1001(e)(3) exception applying: basis is destroyed and the IRS receives a windfall.

In PLR 200127023, the IRS treated the commutation of a charitable remainder trust (CRT) as a taxable exchange and sale by the individual lead interest holder, generating capital gain with zero basis attributable under IRC § 1001(e). Regarding the exception, the IRS stated "The exception contained in § 1001(e)(3) is not applicable, because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party."

PLR 200733014 was substantially similar, where the commutation was ruled in substance to be a taxable sale by the income beneficiary. Regarding the commutation, the IRS noted, "In the present case, although the proposed transaction takes the form of a distribution of the present values of the respective interests of Grantors and Charity, *in substance* it is a sale of Grantors' interest to Charity, the remainder interest holder."

Decanting and Reformations as Taxable Dispositions

Reading the description of the first two PLRs from 2002 discussed above combined with these newer PLRs, readers may be nervous that commonplace reformations and decantings could be a taxable sale or disposition under § 1001. I cannot completely reassure readers on this point.

While there are many PLRs that have found minor changes not to be a disposition, there is no reason that reformations and decantings cannot trigger § 1001 if the changes are material enough. In defining what constitutes a "material difference" for purposes of § 1001(a), the Supreme Court stated that "properties are 'different' in the sense that is 'material' to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent [echoing language in Treas. Reg. § 1.1001-1(a)]. ***Under our interpretation of § 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are "materially different" -- that is, so long as they embody legally distinct entitlements."[22]

[22] *Cottage Savings Assn. v. Comm.*, 499 US 554 (1991).

Most reformations should be safe, but not all. Administrative changes don't give beneficiaries materially different legal entitlements. However, if it's a major change in economic rights, it might. Unitrust conversions have a safe harbor.[23] Mere changes between grantor and non-grantor trust status should be safe, absent extraordinary circumstances.[24] Severances, as discussed above, are also safe, but there is no clear rules as to when a change goes beyond a mere severance. This is a very grey area. For example, if the discretionary income beneficiary gets a new 5/5 withdrawal power and the remaindermen get a restriction on the income beneficiary's testamentary power to appoint to others, that gets closer to a quid pro quo, a material change in legal entitlements, similar to PLR 200231011. Splitting a pot trust in two where the two beneficiaries keep the same rights looks like a severance, but splitting a different trust in two where one beneficiary accelerates from remainderman to current beneficiary and the other gets additional rights may go beyond the severance safe harbor.

[23] Treas. Reg. § 1.643(b)-1 "***A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries."

[24] Rev. Rul. 85-13, CCA 200923024; see Treas. Reg. § 1.1001-2(c), Example 5 and TAM 200011005 and *Madorin v. Comm.*, 84 T.C. 667 (1985) for exceptions when relief of debt in excess of basis triggers gain.

The case law that is citable authority involving commutations and reformations is sparse but leans towards substantial reformations that materially change economic interests being deemed to be dispositions.[25] In *Evans v. Commissioner*, 30 T.C. 798 (1958), the taxpayer exchanged an income interest in trust for a more certain fixed annuity, and this was found to trigger § 1001.

[25] See the discussion of *Evans v. Commissioner*, 30 T.C. 798 (1958) and *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969) in PLR 200231011. In *Evans*, taxpayer exchanged an income interest in trust for a more certain fixed annuity, and was found to trigger § 1001. In *Silverstein*, the trust was terminated, but the income beneficiary was to receive the exact same payments from the remaindermen rather than the trustee and the 7th Circuit found this not to be an exchange. *Silverstein* is not especially helpful, since it seems merely an assignment/change in obligors.

That said, the IRS has approved many reformations in the past that have minor changes in legal entitlements. PLRs 201702005 and 201702006 involved converting pot trusts into separate trusts, yet the IRS ruled that these changes did not trigger § 1001. More far-reaching, in recent PLR 201814005, the IRS ruled that a court reformation that converted a mandatory distribution to a discretionary distribution standard and replaced a beneficiary's rights to withdraw corpus at ages 25 and 30 with testamentary general powers of appointment ("GPOA") at that age did not trigger § 1001: "In this case, the Trust modification will result in increased trustee discretion and will not confer new rights to the beneficiaries or result in any relative shifting of interests between beneficiaries."

The IRS appears to be more sympathetic to cases such as above where the current beneficiary is arguably receiving a decrease rather than an increase in economic rights (as opposed to PLR 200231011 and *Evans*). Would the IRS have granted PL 201814005 had the requested change been reversed, *i.e.* granting a current discretionary beneficiary a mandatory distribution right, perhaps to qualify as a QSST or a BDOT? It's hard to say.

In all the PLRs discussed in this article, the local court approved the commutation or reformation. It's tempting to assume that decanting, which has spread like wildfire in recent years and is rumored to cure cancer, gets around this problem. That is questionable. If a trustee-initiated change approved by a court can be a disposition, there is no reason that an identical trustee-initiated change not approved by a court would not be. Advocates for more dramatic decanting (e.g. SD/NV proponents brag of their statutes permitting removal of mandatory distribution rights and accelerating remainder interests) claim it's completely different because decanting is framed as a distribution to another trust, but there is no clear authority for this distinction when it looks more like a substantial reformation. The IRS has been "studying" this for years and is skeptical where decantings substantially change beneficial interests.[26]

[26] IRS Notice 2011-101: The IRS "will not issue private letter rulings (PLRs) with respect to such transfers [decantings] that result in a change in beneficial interests. See Sections 5.09, 5.16, and 5.17 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111. The IRS generally will continue to issue PLRs with respect to such transfers that do not result in a change to any beneficial interests and do not result in a change in the applicable rule against perpetuities period." Some state statutes, *e.g.*, the Uniform Trust Decanting Act § 19, have excellent language that may protect against decanted trusts being disqualified from various tax benefits, such as the marital deduction, designated beneficiary "see through trust" status or S corporation ownership qualification, but this is unlikely to be helpful in preventing the IRS from arguing a sale or disposition has occurred under *Cottage Savings*.

What about decanting to remove a right to receive the trust corpus at age 40 or otherwise, as in the infamous *Ferri* and *Kaestner* cases?[27] This is a favorite strategy advocated in countless tax and asset protection planning conferences in recent years. If the current beneficiaries keep a discretionary interest as sole current beneficiary coupled with a testamentary GPOA, it more closely resembles PLR 201814005 discussed above (but which, of course, is not citable precedent). Query whether beneficiaries retained a testamentary GPOA in those cases.

[27] These are discussed in prior LISI Newsletters, see *Ferri v. Powell-Ferri: Asset Protection Issues, Perils and Opportunities with Decanting*, *Ed Morrow & Steve Oshins,* LISI Asset Protection Newsletter #240*, Ed Morrow, David Berek, and Raj Malviya on the North Carolina Supreme Court's Affirmation of Kaestner and Its Impact on both North Carolina and Other States' Abilities to Tax Trust Income* LISI Income Tax Planning Newsletter #153 (August 20, 2018).

It could be quite dangerous if the IRS applied IRC § 1001 to such amendments, even if the value of the current beneficiary's interest was dramatically reduced as in cases like *Ferri* and *Kaestner*, due to the zero-basis rule of § 1001(e) and the potential effect on other beneficiaries.[28] No PLRs or cases have gone that far – yet.

[28] The one consolation would be the amount of consideration received in return, if it is merely a discretionary interest in trust with no mandatory distribution, should be valued much lower than prior to the decanting. Some attorneys believe that a discretionary interest in trust has no value whatsoever and that it would not even be considered a property interest under federal tax law, but just because Alaska or some other state says it's not a property interest does not make it so for federal tax purposes. That said, the value of such an interest should be quite low. In PLR 8535020, a lifetime limited power of appointment was exercised in a trust wherein income payments to the powerholder/beneficiary were discretionary, thus requiring the IRS to value that interest to determine the amount of the gift. The IRS cited Rev. Rul. 79-327 and stated:

"The fact that the trustee has discretion regarding distributions of income and principal to you is a factor that must be taken into account in determining the fair market value of your beneficial interest, but, as indicated by Rev. Rul. 67-370, the presence of the possibility of your receiving less than the entire income and principal does not warrant our finding that your transfer of the interest is not subject to the tax imposed by section 2501(a) of the Code."

The IRS had no further guidance on how to value a discretionary interest. The larger taxable ramifications in such decantings/reformations may therefore be to remainder beneficiaries, whose economic interest in the trust may dramatically increase. If deemed a disposition, they could use their share of uniform basis to offset such gain, but this may be phantom income if they can't access cash. In a truly dynastic trust where no one has more than a discretionary interest, many attorneys would argue that no beneficiary has any economic rights worth anything, even if the trust has $1 billion in it. Whether the IRS/courts would agree is questionable. I can cite no authority, but it's even possible that they ultimately apply a zero-sum analysis, *i.e.*, if the trust is worth $1 billion, then the collective equitable interests held by the various beneficiaries must be worth that amount so that as one beneficiary's interest decreases others must increase accordingly. The uniform basis rules have no examples of valuing discretionary interests, but consider a current discretionary interest a term interest. See Treas. Reg. § 1.1014-5(a) and § 1.1001-1(f)(2)(i).

It Could Be Much Worse…

In these PLRs, the trust had been established for over 30 years. What if the trust had been settled less than a year before the commutation? The tax rate would almost double due to short-term capital gains being taxed at ordinary income tax rates (top rate 37% v. 20% for long-term capital gains). Similarly, any assets that the trust had purchased within one year could also trigger short term capital gains as to the portion G3 is deemed to pay for G2 and G4's shares (the PLRs did not indicate whether there were any such assets).

It's unlikely that this trust contained inherited retirement plans, but many trusts do. Which bold reader wants to promise clients what the result of this would be? In compliance mode, we could argue that transferring an inherited IRA in kind from a trust to beneficiaries shouldn't trigger any income, but recall the IRS deems a commutation to be a sale by G2 and G4 to G3, with *Kenan* gain to G3 on paying off G2 and G4. The IRS does not take kindly to such transactions with inherited retirement plans involved.[29]

[29] See IRS Chief Counsel Memorandum (CCM) 200644020 regarding the *Kenan* rule applied to IRA/401(k) income in respect of a decedent funding a pecuniary obligation (which is a somewhat debatable conclusion, as IRC § 691(c)/IRD rules arguably trump this, but it's best in planning to avoid a fight).

Similarly, what if the trust was the party to an installment sale or had § 179 property or loss assets that had to fund those two shares? Related party rules could hold some nasty surprises.

Moreover, the rulings found that G3, the Current Remaindermen, did not incur any taxable sale or disposition despite turning a mere remainder interest into cold hard cash and other assets. This is hardly an inevitable conclusion under IRC § 1001. The more rational interpretation is that all three groups disposed of their shares.

Application of § 1001 to reformations and decantings that do not involve full terminations would involve even worse complications due to phantom income. In these PLRs, the beneficiaries all have liquid funds to pay the income tax, but in a reformation deemed to be a constructive disposition, they may not.

Conclusions and Solutions Around the IRC § 1001(e) Destruction of Basis

In short, these PLRs point out significant income tax dangers to early termination of trusts (and potentially, extensive reformations). Practitioners should consider the pros and cons of less drastic alternatives that may solve the perceived problems of the trust without triggering § 1001 – or worse, the zero-basis apocalypse of § 1001(e). There may be several potential solutions when the parties wish to commute a trust (remember that spendthrift provisions generally prevent transfers of trust interests, but such provisions can be removed by decanting or other reformation):[30]

> [30] Some state statutes even permit a beneficiary/trustee to decant and do so, which may have significant estate tax and asset protection ramifications, see *Ed Morrow: Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary Controlled, Irrevocable Trust*, LISI Asset Protection Planning Newsletter #339 (March 9, 2017). Simply removing a spendthrift provision should not be a material enough change by itself to cause a sale or disposition, see, *e.g.* PLR 201136011, PLR 201026014 (both of which involved multiple related sequential PLRs), which so ruled.[2750]

Either the income beneficiary or the remaindermen could gift their interest to the other rather than sell or commute the interest. This may be acceptable in smaller trust scenarios where estate/gift tax is not an issue. In these rulings, the Son's "net worth has grown significantly, such that he does not need income from [the trust] for his support". So why didn't he simply release his interest and unilaterally make a gift? Apparently he did not care about estate/GST tax too much if he was willing to add so much to his estate through a commutation. If that would be too much and cause a gift tax, they could bifurcate the trust via qualified severance and G2 could release only the interest corresponding to the amount of potentially taxable gift desired.[31] While a gift could be construed as a disposition triggering § 1001(e), provided it was not a net gift agreement, bargain sale or trigger debt in excess of basis issues, there would be no consideration to tax as capital gain even if the basis were deemed to be $0.

> [31] See Treas. Reg. § 1.1001-1(h) for qualified severances that do not trigger tax.

Similarly, Son (G2) could have gifted a portion or all of his interest to charity, sui generis or prior to a later commutation. Whether it's a zero-basis asset pursuant to § 1001(e) or not would be

[2750] [My footnote:] Those rulings involved the sale of a remainder interest, which did not implicate Code § 1001(e).

irrelevant (unless, perhaps if gifting to a CRT), and by longstanding case law, it's considered a capital asset, not an assignment of income.[32] This may be much better than simply gifting the income every year.

[32] *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946) *cert. denied*, 330 U.S. 826 (1947); the Service acquiesced in Rev. Rul. 72-243.

The parties could structure a sale that more clearly meets the § 1001(e)(3) exception. Neither the statute nor the regulations have a related party rule. Treas. Reg. § 1.1001-1(f)(3) states that the exception in IRC § 1001(e)(3) applies when the entire interest in property is sold or otherwise disposed of as part of a single transaction to a third person or persons. Thus, both sets of parties could sell their interest to any third party, who would then own all trust interests and merge/collapse the trust and be able to pay them each their commuted value.[33] One might fear that the IRS could argue substance over form, but here the transaction would be squarely within the statute and regulation. Congress could have easily added a related party rule as it often does, but chose not to. Who else but a related or subordinate party would want to bother?

[33] Common law doctrine of merger can be found at UTC § 402(a)(5) and *Restatement of Trusts, Third*, § 69. If an LLC is used and then holds all beneficial interests, there may be another hurdle in that state law may prohibit LLCs acting as trustees without qualification as a bank or trust company, so it may be wise to research this issue under state law before so doing or use an individual buyer.

The parties could instead divide the trust via tax-free severance. Treas. Reg. § 1.1001-1(h) provides that a severance is not a taxable exchange if state statute or the governing instrument authorizes it and any non-pro-rata funding. State law may permit such a division and non-pro-rata funding (in fact, judges would be more likely to approve than an outright termination). What if the court order had instead divided the trust into two trusts (or more) with liberal current terms for each group of beneficiaries (G2, G3, G4)? Arguably this is still a severance. However, such a division between generations is quite different from most traditional severances (such as dividing a pot or separate share trust), so it's still unclear whether *Cottage Savings* analysis or the severance regulation would win the day.

If the driving force was that G3 or G4 needed money for consumption, they could sell all or a portion of their remainder interest. Provided they do not both sell to G2, this would not have terminated the trust or affected G2, yet the zero-basis rule would not apply and they could use their share of uniform basis to reduce gain on sale.

They might contribute their trust share to an LLC taxed as a partnership. The LLC, just like any other purchaser, would then own all interests in the trust and it could be merged/collapsed and the LLC would own the assets and each beneficiary would thereafter own a % of the LLC in proportion to the prior value of their trust interest. For some families, this might be a great result. Investment partnership diversification rules, which are an exception to the general non-recognition rule, should be considered.[34]

[34] IRC § 721(b), § 351. I did not fully research whether this might somehow be a diversification of the beneficiary's assets which is an exception to the general nonrecognition on contributions to partnerships rule in IRC § 721(a). The capital asset contributed to the LLC/partnership would arguably be the trust interest, not marketable securities that the Code prevents partners from diversifying. When the trust will be immediately merged/collapsed, will the IRS look through to the investments? The trust interests may represent equitable

ownership in marketable securities (assuming that is how the trust is invested), but this is not a situation where the partners are diversifying their holdings in marketable securities, since all parties to the trust would be contributing shares in the same securities even if we looked through the trust. There may be other income triggering situations if the partnership/LLC made non-pro-rata distributions in kind within seven years, but it does appear that the contribution itself should be non-taxable.[2751]

If there is wide discretion to make principal distributions to the income beneficiary (not present in these PLRs), the trustees under most state decanting laws could decant to grant the income beneficiary the lifetime limited power to appoint principal to remaindermen. The powerholder could then appoint the desired value to the remaindermen (over time or lump sum) and the trustee could make a distribution of the remaining principal to the income beneficiary. This may involve a small taxable gift due to the value of the income beneficiary's interest foregone, but the annual exclusion would be available to offset such gifts.[35] It does not seem so drastic as to be a material change that would be a disposition.

[35] Rev. Rul. 79-327, *Estate of Regester*, 83 T.C. 1 (1984), though contrary is *Self v. United States*, 142 F.Supp. 939 (1956). The IRS, in TAM 9419007, has indicated it will follow *Regester* (finding a gift) and not *Self*. The gift would not be the entire amount of the distribution. It does not necessarily affect GST exempt/grandfathered status – see *e.g.*, PLR 200243026.

Since the son (G2) didn't need the money, the parties could have simply amended the trust to grant son the power to withdraw the income instead of automatically receiving it – this is hardly a material change in the parties' rights that would be a sale or disposition, yet this would clearly shift the income taxation of such income to the son without requiring he take any of the money. This would permit the trust to grow income tax free, at least to the extent of any taxable income allocated to fiduciary accounting income, which might in many cases be all of the income (or easily could be, by change in investments or trustee allocation).[36]

[36] For more on this concept, see *IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)*, LISI Estate Planning Newsletter #2587 (Sept 5, 2017), updated and reorganized at Morrow, Edwin P., *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)*. Available at SSRN: https://ssrn.com/abstract=3165592. To avoid any contribution for gift/GST purposes, amounts over IRC §2514's 5/5 lapse protection should be withdrawn or hang. There may be compelling reasons to apply the withdrawal power over all taxable income instead of only over all accounting income, because in the latter case the 5% lapse would be calculated only on the accounting income rather than the entire corpus.[2752]

The trustees could instead petition the court to amend the trust to grant wide discretion to the trustees to distribute principal currently to both the income beneficiary and the remaindermen (a discretionary pot trust) and the trustees could thereafter use their discretion to make distributions of the proceeds to either or both. There would still be some risk here, since there is a chance of substance over form or step transaction attack, and radical modifications to a trust such as this might still be considered a disposition, as discussed previously. Moreover,

[2751] [My footnote:] The most important analysis of this issue (but not of the specific transaction Ed is describing) is in part II.M.3.b Exception: Diversification of Investment Risk. Footnote 3245 in part II.M.2.a Initial Incorporation – Generally cross-references part II.M.3.b.

[2752] [My footnote:] See part III.B.2.i.vi Portion Owned When a Gift Over $5,000 is Made whenever a party gives up a mandatory income right, there is the potential for a taxable gift to occur, even if only passively acquiesced to. Still, this stands a better chance at avoiding a disposition than a commutation.

If the driving force behind termination were to access capital for closely-held investments, they could have amended the trust to be a directed trust to permit the trust to invest in such assets (and reduce trustee fees from higher fully managed to lesser directed trust fees). This kind of change should not be a taxable event.

Similarly, depending on the driving force for termination, the trust could have been amended to permit loaning money to beneficiaries. Provided it's not a de facto termination, lending should not be a taxable event either.

There are probably many other variations on the above. Trusts with robust trust protector language may have the ability to make some of these changes without going to court or crafting a non-judicial settlement agreement.

Although not present in these PLRs, remember that for any transfer or commutation involving termination of a QTIP trust, IRC § 2519 would apply to trigger a net gift by the spouse of the remaindermen's portion of the trust (IRC § 2514 would apply to a gift involving a marital GPOA trust). This may not be a disaster, and in many cases could work out much better than had the spouse disclaimed and the estate paid estate tax instead of gift tax, but this should certainly be considered in the calculus.

In conclusion, be careful to weigh the potential income tax impact of commutations and early terminations and even dramatic amendments/reformations that materially change the economic interests of the parties (especially if a beneficiary is being removed). There is no bright line test as to when a sale will be deemed to occur and it could be a very expensive proposition if it is later found to be so but not reported as such.

II.J.18.f. Commutation vs Mere Division

I agree with the criticism in part II.J.18.e Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations that Rev. Rul. 69-486 does not support the conclusion of Letter Ruling 201932001 (and its companion rulings) and his comment that Reg. § 1.1001-1(h) prevents gain recognition when the form and substance are a distribution rather than sale of beneficial interest, especially in light of Reg. § 26.2642-6(j), Example (3).[2753]

Furthermore, when the current beneficiaries and remaindermen are related, I do not see any policy reason for Code § 1001(e)(1) to apply.[2754]

Ultimately, however, one needs to reconcile the continued existence of law on commutations in part II.J.18.d, which was not altered when Reg. § 1.1001-1(h) was adopted, with the potentially broad protection of Reg. § 1.1001-1(h) that applies to divisions under part II.J.18.a. In weighing these arguments, consider Reg. § 1.1002-1(b), "Strict construction of exceptions from general rule," which provides:

[2753] Reg. § 1.1001-1(h) and Reg. § 26.2642-6(j), Example (3), are reproduced in the text accompanying and following fn 2709.
[2754] See text accompanying and following fn in part II.J.18.d Trust Commutations.

> The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

Absent Reg. § 1.1002-1(b), Reg. § 1.1001-1(h) could be broadly construed to protect most commutations. Reg. § 1.1002-1(b) informs us that we need to look deeply into the purpose of Reg. § 1.1002-1(b) and make sure it suffices to override the law of exchanges.

Ultimately, we need to see whether a beneficial interest constitutes an entitlement that one can compare to a measurable expectation of financial benefits. Certainly, an income interest or its equivalent (unitrust, annuity, etc.) can be measured. Ascertainable standards tend to constitute a measurable economic interest. For guidance in measuring beneficial interests for gift tax purposes, see part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts.

Transferring an entire beneficial interest to a new trust but in a modified form can trigger a Code § 2702 gift of the entire beneficial interest,[2755] so if the entire beneficial interest is transferred and the distribution rules are different then they may need to be in the form of a unitrust or annuity. A trust division, where the original trust continues intact and property is transferred to a new trust, would be limited in gift tax consequence to the amount transferred and therefore less risky than reforming the entire beneficial interest. Furthermore, guidance on trust divisions in part II.J.18.a tends to show that taking a trust with multiple beneficiaries and dividing it into a separate trust for each beneficiary with the same distribution standards does not constitute a gift or an income-taxable exchange.

When is a change of an expected series of distributions material? Given the lack of concrete examples for trusts, one might see whether a change in a right to a series of payments in other areas of the law might help. Reg. § 1.1001-3, "Modifications of debt instruments," provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of Reg. § 1.1001-1(a).[2756] For that purpose, a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent.[2757] Generally, a modification of a

[2755] See part III.B.7.d Code § 2702 Overview.

[2756] Reg. § 1.1001-3(a), which continues:

> This section applies to any modification of a debt instrument, regardless of the form of the modification. For example, this section applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. This section also applies to a modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties. This section, however, does not apply to exchanges of debt instruments between holders.

[2757] Reg. § 1.1001-3(b), which continues:

debt instrument is any alteration of the payor's or payee's legal rights or obligations,[2758] unless that change occurs by operation of the terms of a debt instrument[2759] and is not within the list of changes that constitute a modification.[2760] Generally, a modification is significant only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[2761] Although the rules for when a change of

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> A modification that is not a significant modification is not an exchange for purposes of § 1.1001-1(a). Paragraphs (c) and (d) of this section define the term modification and contain examples illustrating the application of the rule. Paragraphs (e) and (f) of this section provide rules for determining when a modification is a significant modification. Paragraph (f) of this section also provides rules for determining whether the modified instrument received in an exchange will be classified as an instrument or property right that is not debt for federal income tax purposes. Paragraph (g) of this section contains examples illustrating the application of the rules in paragraphs (e) and (f) of this section.

[2758] Reg. § 1.1001-3(c)(1)(i), "Alteration of terms," provides:

> A modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

[2759] Reg. § 1.1001-3(c)(1)(ii), "Alterations occurring by operation of the terms of a debt instrument," provides:

> Except as provided in paragraph (c)(2) of this section, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

[2760] Reg. § 1.1001-3(c)(2), "Exceptions," provides:

> The alterations described in this paragraph (c)(2) are modifications, even if the alterations occur by operation of the terms of a debt instrument.
>
> (i) *Change in obligor or nature of instrument*. An alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification.
>
> (ii) *Property that is not debt*. An alteration that results in an instrument or property right that is not debt for Federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer (notwithstanding paragraph (c)(2)(iii) of this section). The rules of paragraph (f)(7) of this section apply to determine whether an alteration or modification results in an instrument or property right that is not debt.
>
> (iii) *Certain alterations resulting from the exercise of an option*. An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless—
>
> (A) The option is unilateral (as defined in paragraph (c)(3) of this section); and
>
> (B) In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.

[2761] Reg. § 1.1001-3(e), "Significant modifications," provides:

> Whether the modification of a debt instrument is a significant modification is determined under the rules of this paragraph (e). Paragraph (e)(1) of this section provides a general rule for determining the significance of modifications not otherwise addressed in this paragraph (e). Paragraphs (e)(2) through (6) of this section provide specific rules for determining the significance of certain types of modifications. Paragraph (f) of this section provides rules of application, including rules for modifications that are effective on a deferred basis or upon the occurrence of a contingency.

yield are provided,[2762] consider that a trustee can have significant discretion in determining how much is allocated to income in a mandatory income trust without triggering any transfer tax consequences.[2763] A material deferral of scheduled payments[2764] is a significant modification

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Reg. § 1.1001-3(e)(1), "General rule," provides:

> Except as otherwise provided in paragraphs (e)(2) through (e)(6) of this section, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are alt ered and the degree to which they are altered are economically significant. In making a determination under this paragraph (e)(1), all modifications to the debt instrument (other than modifications subject to paragraphs (e)(2) through (6) of this section) are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant.

[2762] Reg. § 1.1001-3(e)(2), "Change in yield," provides:

> (i) *Scope of rule*. This paragraph (e)(2) applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to § 1.1272-1(c), debt instruments that provide for a fixed yield subject to § 1.1272-1(d) (such as certain demand loans), and variable rate debt instruments. Whether a change in the yield of other debt instruments (for example, a contingent payment debt instrument) is a significant modification is determined under paragraph (e)(1) of this section.
>
> (ii) *In general*. A change in the yield of a debt instrument is a significant modification if the yield computed under paragraph (e)(2)(iii) of this section varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of—
>
> (A) ¼ of one percent (25 basis points); or
>
> (B) 5 percent of the annual yield of the unmodified instrument (.05 × annual yield).
>
> (iii) *Yield of the modified instrument*.
>
> (A) *In general*. The yield computed under this paragraph (e)(2)(iii) is the annual yield of a debt instrument with—
>
> (1) an issue price equal to the adjusted issue price of the unmodified instrument on the date of the modification (increased by any accrued but unpaid interest and decreased by any accrued bond issuance premium not yet taken into account, and increased or decreased, respectively, to reflect payments made to the issuer or to the holder as consideration for the modification); and
>
> (2) payments equal to the payments on the modified debt instrument from the date of the modification.
>
> (B) *Prepayment penalty*. For purposes of this paragraph (e)(2)(iii), a commercially reasonable prepayment penalty for a pro rata prepayment (as defined in § 1.1275-2(f)) is not consideration for a modification of a debt instrument and is not taken into account in determining the yield of the modified instrument.
>
> (iv) *Variable rate debt instruments*. For purposes of this paragraph (e)(2), the annual yield of a variable rate debt instrument is the annual yield of the equivalent fixed rate debt instrument (as defined in § 1.1275-5(e)) which is constructed based on the terms of the instrument (either modified or unmodified, whichever is applicable) as of the date of the modification.

[2763] See fns 2531-2535 and accompanying text in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law. Also note that ascertainable standards may include significant flexibility; see fn 2330 in part II.J.3.h Drafting for Flexibility in Trust Income Taxation.

[2764] Reg. § 1.1001-3(e)(3), "Changes in timing of payments," begins with (i), "In general," which provides:

> A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments.

unless it falls within a safe harbor.[2765] Other rules relate to a change in obligor (which might be relevant in the context of a trust division) or security,[2766] changes in the nature of a debt instrument,[2767] and accounting or financial covenants.[2768]

However, modifying a mandatory income trust to allow the trustees to accumulate income and then require any accumulated income to be paid to the beneficiary's estate did not have any income, gift, or GST tax consequences. See part II.J.5.b.iii Modifying a Mandatory Income Trust to Make It Discretionary Income.

Considering all of the sources described above, if a trust is purely discretionary (nor ascertainable standards) and its remainderman are also current permissible distributees, then arguably nobody has any measurable interest, in which case the trustee may be able to divide the trust among all the beneficiaries without any income or gift tax consequences. How each situation compares to this ideal and whether any beneficiary is gifting or exchanging an interest in a trust depends on the circumstances.

[2765] Reg. § 1.1001-3(e)(3)(ii), "Safe-harbor period," which provides:

> The deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument. For purposes of this paragraph (e)(3)(ii), the term of an instrument is determined without regard to any option to extend the original maturity and deferrals of de minimis payments are ignored. If the period during which payments are deferred is less than the full safe-harbor period, the unused portion of the period remains a safe-harbor period for any subsequent deferral of payments on the instrument.

[2766] Reg. § 1.1001-3(e)(4). Generally, Reg. § 1.1001-3(e)(4)(vi)(A)(1) provides that "a change in payment expectations occurs if, as a result of a transaction":

> (1) There is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification; or
>
> (2) There is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

Quaery whether a similar analysis might apply as to whether a trust division leaves each trust with the ability to make the distributions that were expected before the distribution.

[2767] Reg. § 1.1001-3(e)(5).

[2768] Reg. § 1.1001-3(e)(6).

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.[3949] Specifically:[3950]

> 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,[3951] 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;[3952] given that 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.[3953]

[3949] 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.

[3950] Reg. § 1.101-1(f)(5).

[3951] 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.

[3952] 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.

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).

[3953] *James F. Waters, Inc. v. Commissioner*, 160 F.2d 596 (9th Cir. 1947) (prior version of this statute).

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,[3954] 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.[3955] This exception looks at the deemed owner of a grantor trust.[3956] A gift subject to a policy loan that is not in excess of basis is a substituted basis

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[3954] 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.

[3955] Code § 101(a)(2)(A), (B).

[3956] Rev. Rul. 2007-13 posited the following situations:

> Situation 1. 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.
>
> 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

transaction that does not trigger the transfer-for-value rule.[3957] A transfer of an interest in a partnership that owns a life insurance policy is not subject to the transfer for value rules if the transfer does not constitute a termination of the partnership.[3958] Similarly, contributing a life

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> 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.

[3957] 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 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.

[3958] Letter Ruling 200826009. Note, however, that Rev. Proc. 2011-3, Section 3.01(8) states that the IRS will not issue letter rulings on:

insurance policy to a partnership in a Code § 721 nontaxable transfer[3959] is a substituted basis transaction that is not subject to the transfer for value rules.[3960]

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."[3961] "Indirectly" includes "the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract."[3962] 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.[3963] Thus, the death benefit generally is taxable, to the extent described in fn 3949.

- Various reporting requirements apply when the death benefit is paid.[3964]

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 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

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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.

3959 See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

3960 Letter Ruling 201308019.

3961 Code § 101(a)(3)(B).

3962 Code § 101(a)(3)(B).

3963 Code § 101(a)(3)(A).

3964 Code § 6050Y, which is reproduced in part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.

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 otherpurposes, 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.[3965]

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.
>
> 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

[3965] For more about these nuances, see part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance, especially fn 4010.

> 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).[3966]
>
> (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, 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

[3966] [my footnote:] For Code § 101(j), see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

> 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.[3967]

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 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

[3967] [My footnote:] I was that commenter.

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 3950, 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)[3968] – 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.[3969]

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:[3970]

> 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 transfer of an interest in a life insurance contract to the beneficiary until the

[3968] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
[3969] Especially text accompanying fn 4005, as well as Example (2) that is discussed in the text accompanying fn 3999.
[3970] 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."

> 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[3971]

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

[3971] [My footnote – not in the preamble:] For why this exception may be perceived to be too narrow, see text accompanying fn 3982 in part II.Q.4.b.ii.(c) "Reportable Policy Sale".

carrier should be 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:[3972]

> 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 4215 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.

[3972] 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 4009.

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 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:[3973]

> 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:[3974]

> For purposes of this section and section 6050Y, the acquisition of an interest in a life insurance contract may be direct or indirect.

[3973] 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."

[3974] For the significance of indirect acquisitions under Reg. § 1.101-1(e)(3)(ii), see text accompanying fn 4011 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 3981 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

(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 (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:[3975]

> 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 1666.

[3975] 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."

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 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[3976] and for whether certain reporting must be done.[3977]

The preamble to the proposed regulations explains:[3978]

> 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

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[3976] 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.

[3977] See part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.

[3978] 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."

> 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:[3979]

> 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.

The preamble to the proposed regulations explains exceptions:[3980]

> 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**
>
> 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

[3979] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 3974 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

[3980] 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."

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.

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:[3981]

(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).

[3981] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 3974 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

(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 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.[3982] 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.)[3983]

Reg. § 1.101-1(c)(2)(i) refers to Reg. § 1.101-1(g)(13),[3984] 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 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)[3985] elaborates on Reg. § 1.101-1(c)(2)(iii)(B), providing:

> *Example 15*. The facts are the same as in Example 14[3986] 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

[3982] For the preamble discussing this issue, see fn 3971 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

[3983] See Reg. § 1.101-1(d)(2)(ii).

[3984] 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....

[3985] 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....

[3986] [Not in the regulation - click to go to:] Example 14.

> 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:[3987]

> 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 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

[3987] 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."

> 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**
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> 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.[3988] 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."[3989] 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 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

[3988] [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.
[3989] [my footnote:] ACTEC Fellow Michael Van Cise was that commenter.

the charitable organization's services in some manner.[3990] 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.

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.

[3990] [my footnote:] I was that commenter; see fn 3988.

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 3937-3939 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)[3991] 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)[3992] 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 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

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[3991] 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....

[3992] 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....

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:[3993]

> 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 (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

[3993] 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."

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)(*l*) 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.[3994]

[3994] Reg. § 1.101-1(b)(1)(ii)(B)(1) is applied is Example (3), which is discussed in the text accompanying fn 4000 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.[3995]

Examples (10) through (12) in Reg. § 1.101-1(g)(10) through(12)[3996] 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)(*l*) 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.

[3995] Especially text accompanying fn 4004.

[3996] 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....

(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 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)[3997] 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.

[3997] 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....

(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 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 woulkd not have applied.[3998]

Example (2) cleansed the policy by a gratuitous transfer to the insured under Reg. § 1.101-1(b)(2)(i).[3999]

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).[4000] 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)[4001] 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

[3998] See Rev. Rul. 2007-13, reproduced in fn 3956 in part II.Q.4.b.i Transfer for Value Rule Generally.

[3999] Fn 4005 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 3969 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

[4000] See text accompanying and preceding fn 3994 in part II.Q.4.b.ii.(d) Transfer With Substituted Basis or To Permitted Transferee When Not a Reportable Policy Sale.

[4001] 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 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.

(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)[4002] 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

[4002] 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....

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, 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)[4003]:

(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

[4003] 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....

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 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.[4004] 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."[4005] 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;

[4004] Reg. § 1.101-1(b)(1)(ii)(B)(3) is reproduced in the text preceding fn 3995.
[4005] Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn 3969 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

(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.

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).[4006]

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).[4007]

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."[4008] 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,"[4009] 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

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[4006] [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).

[4007] [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).

[4008] Code § 101(a)(2).

[4009] Reg. § 1.101-1(e)(1) is reproduced in the text accompanying fn 3972.

income, direct ownership of a policy (in whole or in part) must be subjected to a "transfer for a valuable consideration." [4010] 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.[4011] 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 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:[4012]

> 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.[4013] 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 consequnces 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."[4014]

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

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[4010] For a discussion of legislative history supporting this idea, see fn 3965 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.
[4011] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 3974 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 3981 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.
[4012] 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 3981 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.
[4013] 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 3981 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.
[4014] Code § 101(a)(2).

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.[4015] 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,[4016] adding Code § 1016(a)(1)(B), which provides:

> 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.

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 have the same insureds.[4017] A taxpayer may roll over part of a policy into another policy.[4018]

[4015] See Rev. Ruls. 2009-13 and 2009-14. Commentators disagreed with the IRS' position.

[4016] 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.

[4017] 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.

A life insurance contract may be swapped into another life insurance, endowment, annuity, or qualified long-term care insurance contract.[4019] If one insured in a second-to-die policy

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.

[4018] 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).

[4019] 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 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 has died, Code § 1035 may apply to the exchange of that policy for a policy on the life of only the surviving insured.[4020] 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.[4021]

2. The transfer for value rules might cause the death benefit to be subject to income tax.[4022]

When life insurance is sold in a taxable transaction, the IRS' position is that:[4023]

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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.

[4020] 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).

[4021] 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 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.

[4022] See text accompanying fns. 3949-3960.

[4023] 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).

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.

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

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"),[4024] and

    - Capital gain to the extent of the balance.

2. The selling taxpayer's basis is reduced by the cost of insurance.[4025]

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.[4026] Rev. Rul. 2009-14 discusses tax consequences to the purchaser of a term life insurance policy.

Using a life insurance LLC might solve most or all of these issues.[4027]

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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).

[4024] 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. 4040.

[4025] Commentators strongly disagree with the IRS' position, accusing it of cherry-picking authority. See, *e.g.*, "Ouch, My Head Hurts – Treasury Rules That 'Basis' Is Lower Than 'Investment in the Contract,'" Northwestern Mutual *Advanced Planning Bulletin*, June 2009, citing cases regarding life insurance, including *Arnfeld v. U.S.*, 163 F.Supp. 865 (Ct. Cl. 1958); *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960); *Roff v. Commissioner*, 304 F.2d 450 (3rd Cir. 1962); *First National Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962); and *Gallun v. Commissioner*, 327 F.2d 809 (7th Cir. 1964). The *Advanced Planning Bulletin* also cited authority regarding capitalizing expenditures generally, including Reg. § 1.263(a)-4; *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992); and *Federal Express Corp. v. Commissioner*, 412 F.3d 617 (6th Cir. 2005). The *Advanced Planning Bulletin* was also published as Finn, Revenue Rulings 2009-13 & 2009-14 - More on Income Tax Consequences of Surrender and Sale of Life Insurance Policies, *Steve Leimberg's Estate Planning Email Newsletter* as Archive Message #1493 (7/23/2009). Newsletters #1457 (Zaritsky), 1459 (Mancini and Brody), and 1462 (Blattmachr and Gans) also discuss Rev. Ruls. 2009-13 and 2009-14. If a life insurance company demutualizes, none of the policy's basis is allocated to the stock that policyholders receive. *Dorrance v. U.S.*, 807 F.3d 1210 (9th Cir. 2015).

[4026] Rev. Rul. 2009-13, Situation 1.

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,[4028] the rules described below do not apply.[4029]

Generally, distributions (other than tax-free death benefits) from life insurance contracts are not taxable "the extent allocable to the investment in the contract."[4030] Dividends used to pay premiums are not taxable.[4031] 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[4032] and are treated as distributions when those exceptions apply.[4033] However, distributions 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.[4034]

Any distributions in excess of "investment in the contract" constitute ordinary income.[4035] However, Code § 1234A might be used to argue that income on surrender should be all capital gain.[4036]

"Investment in the contract":[4037]

> 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.

[4027] 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.

[4028] Code § 101(a)(1).

[4029] 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.

[4030] Code §§ 72(e)(1), 72(e)(2)(B)(ii).

[4031] Code § 72(e)(4)(B).

[4032] Code § 72(e)(4)(A) includes various exceptions.

[4033] Code § 72(e)(4)(A) includes various exceptions.

[4034] Code § 72(e)(10), using the definition of modified endowment contract in Code § 7702A.

[4035] Code § 72(e)(2).

[4036] 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.

[4037] Code § 72(e)(6).

However, charges relating to a long-term insurance component of a policy may reduce "investment in the contract."[4038]

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 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.

[4038] 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).

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, [4039] Situation 2,[4040] 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.[4041]

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

3. Be careful to fit within an exception to the transfer for value rules[4042] 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[4043]) receives a new tax basis when that individual dies if that property is included in that individual's estate for estate tax purposes.[4044]

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.

[4039] See fn 4016 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.
[4040] See fn. 4023.
[4041] See text accompanying fn. 4023.
[4042] Code § 101(a)(2).
[4043] 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.
[4044] Code § 1014, which applies to more than just what this sentence describes.

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.[4045] 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.[4046] Regulations provide:[4047]

> **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.

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."[4048]

IRD does not include "items which are excluded from gross income under subtitle A."[4049]

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)[4050] or excluded from income (if received as a nontaxable death benefit).[4051] 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.

[4045] Code § 1014(b)(9); Reg. § 1.1014-2(b)(3)(i).
[4046] Code § 1014(c).
[4047] Reg. § 1.691(a)-1(b).
[4048] 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.
[4049] Reg. § 1.691(a)-1(c).
[4050] Code § 72(e).
[4051] See fns. 4028-4029.

This analysis is consistent with a test the Tax Court formulated for determining whether proceeds from a sale contract are IRD. The test considers:[4052]

[4052] *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*, 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.

(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)]." *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:[4053]

> 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:[4054]

> 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 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 52)).

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[4055] 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.[4056] 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),[4057] do not constitute IRD unless

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[4053] 74 T.C. at 643-44.

[4054] 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 fn. 1933.

[4055] See fn 4016 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.

[4056] See fn. 4023.

[4057] 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

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"[4058] 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, that classification is irrelevant, because the Code § 1014 basis step-up rules apply to more than just capital assets.[4059] 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,[4060] 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.[4061]

> 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. 1474.

[4058] 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.

[4059] 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 fn. 1933, found in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[4060] See fn 4016 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.

[4061] 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. 4052), 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

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[4062] do not make the death benefit taxable.[4063]

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), 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."

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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.

[4062] See part II.Q.4.a Funding the Buy-Sell, especially fns. 3949-3960.

[4063] 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.

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.[4064] The IRS has an audit techniques guide on split-dollar arrangements.[4065]

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 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.[4066] 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

[4064] *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).

[4065] 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.

[4066] The reimbursement obligation was nonrecourse – paid only out of the policy and not personally by the employee.

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,[4067] and the parties need to make an election to give effect to the loan for income and gift tax purposes.[4068] 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[4069] and Rev. Rul. 2003-105, so long as they are not "materially 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)[4070] or 264(f) (limiting deductions for interest expense allocable to unborrowed policy cash value).[4071]

The economic benefit regime might also trigger the harsh nonqualified deferred compensation rules of Code § 409A.[4072] Although the Code § 409A risk described in fn. 4072 is much smaller under Reg. § 1.61-22 than under prior law, be careful to consider it in either case.[4073]

[4067] Stated interest that is not payable annually triggers the Code § 1272 original issue discount (OID) rules. See text accompanying fns 4115-4120 in part Split-Dollar Loans under Reg. § 1.7872-15.

[4068] See text accompanying fns 4129-4130 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4069] 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.
>
> 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).

[4070] 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).

[4071] Notice 2008-42.

[4072] See text accompanying fns. 3924-3925.

[4073] 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

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 4069 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 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.

> 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; see fn. 3943. 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.

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[4074] 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 -
>
> (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.[4075]

The following constitutes a split-dollar compensatory arrangement:[4076]

> (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;[4077]

[4074] See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.
[4075] Reg. § 1.61-22(b)(2)(i).
[4076] Reg. § 1.61-22(b)(2)(ii).

(B) The employer or service recipient 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 employee or service provider or is any person whom the employee or service provider would reasonably be expected to designate as the beneficiary; or[4078]

[4077] *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.

[4078] *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.);

(2) The employee or service provider has any interest in the policy cash value of the life insurance contract.[4079]

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.[4080]

The following constitutes a split-dollar shareholder arrangement:[4081]

(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-

> *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.

[4079] *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.
>
> 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.

[4080] *De Los Santos v. Commissioner*, T.C. Memo. 2018-155.

[4081] Reg. § 1.61-22(b)(2)(iii).

(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).[4082] Generally, the split-dollar economic benefit regime[4083] applies to any arrangement that is not subject to the split-dollar loan regime.[4084] 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.[4085]

[4082] 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.

[4083] The regulatory framework for the split-dollar economic benefit regime is valid. *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015).

[4084] Reg. § 1.61-22(b)(3)(i).

[4085] 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

However:[4086]

(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 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.[4087]

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

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.

[4086] Reg. § 1.61-22(c)(1)(ii)(A).

[4087] Especially fns. 4151-4153.

> 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).

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.[4088]

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.[4089] Policy cash value excludes surrender charges or other similar charges or

[4088] 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 250, citing Reg. § 1.1361-1(l)(2)(i)) and II.A.2.i.iii Disproportionate Distributions.

[4089] 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;

reductions and includes policy cash value attributable to paid-up additions.[4090] 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.[4091] Note that the policy's being 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.[4092]

(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).

[4090] Reg. § 1.61-22(d)(4)(i).

[4091] 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.

[4092] See fns. 4151-4153, 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

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.

> 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 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.

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):[4093]

(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:[4094]

> 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],[4095] a contribution to capital, a gift, or other transfer depending on the relationship between the owner and the non-owner.

The owner is the only party who is credited with "investment in the contract" under Code § 72(e)(6).[4096]

[4093] 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.

[4094] Reg. § 1.61-22(e)(1).

[4095] The actual text refers to Code § 301.

[4096] 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

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,[4097] then any modification that causes the employer or donor not to be treated as the donor for income tax purposes has the following consequences:[4098]

(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.[4099] After a transfer of an entire life insurance contract,[4100] the transferee generally becomes the owner for Federal income, employment, and gift tax purposes, including for purposes of Reg. § 1.61-22.[4101]

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:

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included by reason of having been paid by the owner as a premium or other consideration for the contract).

[4097] Reg. § 1.61-22(c)(1)(ii)(A), reproduced in the text accompanying fn 4086.

[4098] Reg. § 1.61-22(c)(1)(ii)(B).

[4099] Reg. § 1.61-22(c)(3).

[4100] 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.

[4101] 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.

1. <u>If the non-owner buys the policy</u> (outside of an employment setting – see footnote):[4102]

- 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:[4103]

    - 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)[4104] actually taken into account by the buyer (and the seller for gift tax and employment tax purposes), plus certain consideration[4105] 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.[4106]

  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 current owner.[4107] 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.[4108]

- 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.[4109] Furthermore, the

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[4102] 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.

[4103] Reg. § 1.61-22(g)(1).

[4104] Referring to benefits described in Reg. § 1.61-22(d)(2)(ii) and (iii), which are reproduced in fn. 4089 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4105] Referring to consideration described in Reg. § 1.61-22(d)(1), which is reproduced in the text following fn 4087 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4106] Referring to accounting for benefits under Reg. § 1.61-22(e)(3)(ii) or (g)(1)(ii).

[4107] See part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured.

[4108] See fn 4023 in part II.Q.4.c Income Tax Issues in Transferring Life Insurance Used in Cross-Purchase Agreements.

[4109] 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:

buyer's investment in the contract[4110] treats as premiums paid the greater of the fair market value of the contract or certain amounts accounted for under the split-dollar rules.[4111] Generally, the buyer does not get credit toward "investment in the contract" for the economic benefit of any term portion previously taken into account.[4112]

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).

[4110] 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.

[4111] 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 investment in the contract because such amount was excludable from E's gross income when E had current access to that policy cash value.

[4112] 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

2. If the owner cashes in the policy. 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).[4113]

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.
>
> (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.

> 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 4016 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.

[4113] 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).

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.[4114]

Reg. § 1.7872-15(a)(2) provides:[4115]

(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.

[4114] Reg. § 1.7872-15(b), referring to Reg. § 1.61-22(b) and (c).

[4115] 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.

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 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 <u>paid</u> annually, payments will be deemed made from the borrower to the lender each year, generating interest income[4116] and generally nondeductible interest,[4117] even though no cash changes hands.[4118] If

[4116] Code § 1272.

[4117] 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).

[4118] 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

the split-dollar agreement is between a donor and a donee, consider making the donee be an irrevocable grantor trust, so that no interest income is recognized while the trust is deemed owned by the donor.[4119] 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.

> 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.

[4119] 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.

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 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.[4120]

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,[4121] 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.[4122]

Reg. § 1.7872-15(j) controls over the usual rules governing contingent payments in making loans at the applicable federal rate (AFR).[4123] The lender puts together a projected payment

[4120] See text accompanying fns 4146-4147 in part II.Q.4.f.iv.(b) Loan Regime After Initial Owner Has Died.

[4121] Reg. § 1.7872-15(a)(2)(i)(B), quoted in full in the text accompanying fn 4115.

[4122] 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.

[4123] 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

schedule, which everyone directly or indirectly involved in the loan must use.[4124] 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;[4125] if the insured outlives his 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.[4126] 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).[4127] Treating a nonrecourse payment as contingent may cause that payment to assigned a zero value,[4128] 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.[4129] Unless the IRS provides otherwise, "both the borrower and the lender must sign the representation not later than the last

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paragraph (j), rather than § 1.1275-4, applies to split-dollar loans that provide for one or more contingent payments.

[4124] 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.

[4125] 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.

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.

[4126] 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.

[4127] Reg. § 1.7872-15(j)(2)(ii).

[4128] 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.

[4129] Reg. § 1.7872-15(d)(2)(i).

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."[4130] 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 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."[4131]

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.

[4130] 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.

[4131] Reg, § 1.7872-15(h)(1)(iv).

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.

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.[4132] The payment's nature depends on the relationship between the owner and non-owner.[4133] 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.[4134] 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

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[4132] Reg. § 1.61-22(d)(1), quoted in the text following fn 4087 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4133] The part of § 1.61-22(d)(1) that follows fn 4087 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).

[4134] See fns 4094 and 4102-4108 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

the gain on sale, which the IRS would assert (not necessarily successfully)[4135] 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).[4136]

- 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.[4137]

- Generally, any death benefit not described above is taxable.[4138]

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,[4139] which means that any distribution from a trust or estate should be pick-and-choose fractional instead of pecuniary.[4140]

[4135] See fn 4036 in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy).

[4136] 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.

[4137] Reg. § 1.61-22(f)(3)(i) provides:

> *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.

[4138] 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.

[4139] See part II.Q.4.b Transfer for Value Rule; Basis.

[4140] See part II.J.8.d Distribution in Kind; Specific Bequests.

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.[4141] 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.[4142]

- To the extent of any accrued interest, the payment would have that character.[4143]

- 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.[4144] 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.[4145] However, consider *Morrissette*, in which the split-dollar receivable's owner bequeathed the receivable to the split-dollar obligor.[4146] 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

[4141] See part II.Q.4.f.i Split-Dollar Generally, especially the text accompanying fns 4067-4068.
[4142] 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.
[4143] 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.
[4144] See fns 1990-1991 (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.
[4145] See fns 4089-4092 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.
[4146] See fns 4151-4154 in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

under the loan to be disregarded, eviscerating most of the loan's value for gift tax purposes.[4147]

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.[4148] 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.[4149]

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.[4150]

Apparently taking advantage of this gap, *Estate of Morrissette v. Commissioner*[4151] held that a taxpayer's entering into a heavily discounted generational split-dollar agreement[4152] did not constitute a gift, even though the decedent bequeathed her interest to the other party in the split-dollar arrangement.[4153] In that case, the mother funded life insurance owned by irrevocable

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[4147] Reg. § 1.7872-15(a)(4) is reproduced in full in text preceding the sentence that includes fn 4120 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4148] See text accompanying fns 4134-4135 in part II.Q.4.f.iv.(a) Economic Benefit Model After Initial Owner Has Died.

[4149] See fn 4093 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4150] See fn 4082 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4151] 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*.

[4152] 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 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.

[4153] 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.

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, the mother might have prevented that result.[4154] However, in a similar situation, *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, held that Code §§ 2036, 2038, and 2703[4155] may very well apply, probably not qualifying for the exception

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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 98 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.

[4154] 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. 6569, found in part III.B.5.a 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 4120 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4155] 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)

for a sale for adequate and full consideration that would prevent the former two[4156] from applying because the split dollar receivable was only a small fraction of the amount of money the decedent contributed to the agreement.[4157] The court failed to address Reg. § 20.2038-1(a)(2), which prevents Code § 2038 from applying "if the 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."[4158] 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*.[4159] On February 19, 2019, the court

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> $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.

[4156] 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).

[4157] 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.

[4158] 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)."

[4159] 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

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.

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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.

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 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.

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,[4160] 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.[4161] Although that approach would work for the split-dollar loan regime, it might not 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.[4162] 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. 4161 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

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[4160] 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. 3929.

[4161] 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 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.

[4162] Reg. § 1.61-22(d)(2)(ii) - see fns. 4089 and 4091 for text of the relevant regulations.

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. 4151.

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. 4151); 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,[4163] name the donee as the owner.

Lee Slavutin suggests the following guidelines for drafting generational split dollar agreements:[4164]

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.

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.[4165] An "employer-owned life insurance contract" (a term that applies to

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[4163] See fns. 4151-4153.
[4164] A Post-*Morrissette* Roadmap for Drafting Intergenerational Split Dollar Agreements, *Steve Leimberg's Estate Planning Email Newsletter* - Archive Message #2414 (5/12/2016).
[4165] Code § 101(j).

much more than one would think) does not receive the exclusion unless certain notice and consent requirements are met.[4166]

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.[4167] An "applicable policyholder" means, with respect to any employer-owned life insurance contract, the person described in the preceding sentence who owns the contract[4168] at the time it is issued.[4169]

"Employee" includes a "highly compensated employee" under Code § 414(q), [4170] and Code § 414(q)(1)(A) pulls in people who own at least 5% of the company.[4171] Thus, an owner who is not an employee is an "employee" for purposes of this rule by being a 5% owner.[4172]

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.[4173] 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,

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[4166] Code § 101(j)(1), (2).

[4167] Code § 101(j)(3)(A).

[4168] Code § 101(j)(3)(B)(i).

[4169] 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. 4174.

[4170] Code § 101(j)(5).

[4171] 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.

[4172] 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.

[4173] Code § 101(j)(4).

"applicable policyholder" should mean the person to whom the policy is issued when the insured is an "employee" of that person.[4174]

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.[4175]

- Another qualifying relationship is if, when the contract is issued, the insured is a director, certain highly compensated employees, or a 5% owner.[4176] (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.)[4177]

- 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.[4178]

- 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.[4179] Beware of the proceeds exceeding this use.

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.[4180] It also would guard against

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4174 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.

4175 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. 4170-4172.

4176 Code § 101(j)(2)(A)(ii). The reference to a 5% owner is described in the text accompanying fns. 4170-4172. 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 4171 in part II.Q.4.g.i Analysis of Code § 101(j).

4177 See text accompanying fns. 4167-4169.

4178 Code § 101(j)(2)(B)(i). "Family member" refers to Code § 267(b)(4).

4179 Code § 101(j)(2)(B)(ii).

4180 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:

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 before the application is signed.[4181] 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.[4182] 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);[4183] step transaction concerns might suggest that the insured transfer the policy into a life insurance LLC[4184] instead of waiting long enough (whatever that means) to avoid an assertion of the step transaction doctrine.

> …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.

[4181] Leimberg and Zaritsky, IRS Provides New and Substantial Guidance on Employer-Owned Life Insurance, 36 *Estate Planning*, No. 8, 3 (August 2009).

[4182] 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.

[4183] 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?
>
> 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.

[4184] See part II.Q.4.i Life Insurance LLC.

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 before 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.[4185] "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.[4186]

These rules for life insurance contracts issued or materially changed after August 17, 2006.[4187] Notice 2009-48 elaborates on the rules described above, as well as providing rules for what constitutes a material modification,[4188] including guidance on tax-free exchanges.[4189]

[4185] Code § 6039I(a) is the general reporting requirement, and Reg. § 1.6039I-1 specifies the form.

[4186] Code § 6039I(c).

[4187] 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. 4071-4073.

[4188] 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.

[4189] 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.

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.[4190] However, if the business owns it,[4191] the following rules apply (emphasis added):[4192]

> **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.

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

[4190] A-1.
[4191] Including through a grantor trust that the business established, per A-1.
[4192] After A-3 and before Q-4.

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. 4180 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]

III.B.1.b. Gifts Without Consideration, Including Restructuring Businesses or Trusts

For smaller companies, consider gifts either outright or in trust. Gifts provide more favorable valuation rules than transfers by bequest. Suppose, for example, that a decedent bequeathed 100% of the stock of her business to her children. The bequest is of a single 100% block of stock, so valuation adjustments for lack of control would not apply. However, if while alive she gave a 20% block of stock to each of five children, so that she gave away 100% of all of stock all at once. Each 20% block is valued separately, with valuation adjustments for lack of control.[5933] Proposed regulations would eliminate these valuation adjustments if the gift is made within 3 years of death,[5934] as well as artificially increasing the value beyond customary valuation principles.[5935]

When a donor delivers a properly indorsed stock certificate, when the gift is complete depends on to whom the donor delivers the certificate:[5936]

- If delivered to the donee or the donee's agent, the gift is complete for gift tax purposes on the date of delivery.

- If delivered to the donor's bank or broker as the donor's agent, or to the issuing corporation or its transfer agent, for transfer into the name of the donee, the gift is complete on the date the stock is transferred on the corporation's books.

A gift to a minor should probably be done using the Uniform Transfers to Minors Law unless the gift is in trust. Gifts to minors of partnership interests that are not done in that manner can be problematic, and a conservatorship would be advisable.[5937]

[5933] Rev. Rul. 93-12.

[5934] Prop. Reg. § 25.2704-1(f), Example (4), would be revised to end as follows:

> More than three years before D's death, D transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

For further discussion, see part III.B.7.f.ii.(a) Prop. Reg. § 25.2704-1 Regarding .

[5935] See part III.B.7.f.ii.(b) Prop. Reg. §§ 25.2704-2 and 25.2704-3 Increasing Value.

[5936] Reg. § 25.2511-2(h). When in doubt as to whether the gift was complete, look at the parties' conduct and local law. *Estate of Davenport*, T.C. Memo. 1997-390, *aff'd* 184 F.3d 1176 (10th Cir. 1999) (completed gift when donor signed stock power).

[5937] Reg. § 1.704-1(e)(2)(viii) provides that, except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his or her interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by another person as fiduciary for the sole benefit of the child, and unless there is such judicial supervision of the conduct of the fiduciary as is required by law. Of course that is an income tax regulation and does not on its face apply for gift/estate/GST tax purposes. An income tax regulation can override the state law property rights that apply for gift/estate/GST tax purposes, and the *Pierre* case certainly drove home that point when it held that the check-the-box regulations did not apply to determine the gift tax effect of the transfer of an interest in a single-member LLC. See text accompanying fn 3748. On the other hand, gift/estate/GST tax rules governing partnerships are not well-defined, and courts and the IRS often look to income tax rules when figuring out matters involving

For corporations, the author frequently recommends that clients create nonvoting stock, doing a 19-for-1 nonvoting-for-voting stock dividend.[5938] The parent keeps the voting stock, which represents all of the voting rights, but only 5% of the distribution rights, the parent then transfers part or all of the nonvoting stock.[5939] This restructuring may also be a prelude to the more advanced techniques.

For an S corporation, a simple way to protect the principal from the donee's creditors (including the IRS through estate taxes) would be to use a qualified subchapter S trust (QSST).[5940] A QSST has only one beneficiary, and all of its income must be distributed to that individual. A QSST's income is taxed to its beneficiary,[5941] which means that the trust's fiduciary income tax returns simply report the trust's income on a statement, which the beneficiary then uses to prepare his or her own individual income tax returns. In part III.A.3 Trusts Holding Stock in S Corporations, especially part III.A.3.e.iii Comparing QSSTs to ESBTs, this article discusses the merits of QSSTs compared to other alternatives.

Whether a transfer qualifies for the gift tax annual exclusion depends on whether the property is transferable or income-producing and whether it is outright or in trust.[5942] If the interest transferred is not income-producing, consider giving the donee the right to sell it to the donor for its fair market value within 30 days after the transfer. If, however, the donor received the funds from an unauthorized distribution from a trust, the gift may be undone.[5943]

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partnerships, so a conservatorship would be recommended to avoid an argument, as well as to prove acceptance of the gift.

[5938] See fn 230 for reporting requirements relating to this stock dividend.

[5939] A transfer of nonvoting stock poses much less estate tax risk than a transfer of minority voting stock. See fns 226-228.

[5940] Code § 1361(d)(3).

[5941] Code § 1361(d)(1)(B).

[5942] For qualification of withdrawal rights for the annual exclusion, see *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), and its progeny. For whether an interest in a business entity qualifies for the annual exclusion, see *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd* 335 F.3d 664 (7th Cir. 2003), and its progeny, including *Price v. Commissioner*, T.C. Memo. 2010-2; *Fisher v. U.S.*, 105 A.F.T.R.2d 2010-1347 (D. Ind 2010); *Estate of Wimmer v. Commissioner*, T.C. Memo. 2012-157; *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249 (annual exclusion upheld because LLC's assets produced income). For the amount of the annual exclusion, see Code § 2503(b).

[5943] The official Tax Court syllabus to *Estate of Lillian L. Halpern v. Commissioner*, T.C. Memo. 1995-352:

> A trust established for D's benefit under the will of her husband, H, provided for payment to her of income for life (and principal according to an ascertained standard) and gave her a testamentary general power of appointment. Distributions of trust principal were made to members of D's family, both before and after D, having suffered a stroke, was adjudged incompetent. Those distributions were not authorized by H's will or by court order. All living members of the family, including D, agreed, either personally or through custodians, to the distributions before D's incompetency; D did not agree, even through her guardians, to the distributions after her incompetency, but all the other members of the family did agree.
>
> *Held*, sec. 2038, I.R.C., does not apply to include any of the distributions in D's gross estate. *United States v.* Field, 255 U.S. 257 (1921), followed.
>
> Held further, a Pennsylvania court would not have returned to the marital trust the assets *distributed* to family members prior to D's incompetency, and those assets are therefore not included in D's gross estate under sec. 2041, I.R.C. *Estate of Council v. Commissioner*, 65 T.C. 594 (1975), followed.

For the first year a gift is made to a trust that has generation-skipping transfer (GST) potential, I strongly recommend filing timely (including extensions) a gift tax return stating whether the donor elects to automatically allocate[5944] or not allocate[5945] GST exemption to the donor's current and future gifts to the trust, which election may be revoked or otherwise modified on future timely-filed gift tax returns. "Vested" trusts for grandchildren (or other skip persons) may qualify for the GST annual exclusion, but trusts that do not so qualify are much more common. A trust whose beneficiaries are only skip persons is itself considered a skip person, and gifts to such a trust automatically are allocated GST exemption. Also, a trust that reserves enough benefits for skip persons is a "GST trust" (unless opted out under the first sentence of this paragraph),[5946] gifts to which are "indirect skips" that automatically attract GST exemption.

> *Held* further, a Pennsylvania court would have returned to the marital trust the assets distributed following D's incompetency, and they therefore are included in D's gross estate under sec. 2041, I.R.C.
>
> *Held* further, assets transferred through the 1986 distributions, which occurred within 3 years of D's death, are not included in her gross estate under sec. 2035, 2038, or 2041, I.R.C., by virtue of that timing.

[5944] Code § 2632(b)(5)(A)(ii).

[5945] Code § 2632(b)(5)(A)(i).

[5946] Code § 2632(c)(3)(B) describes what a "GST trust" is. Letter Ruling 200243026 in fn 5957 involved a GST trust. Letter Ruling 201714008 seems to indicate that one ignores unexercised powers of appointment when determining whether a trust is a "GST trust." Letter Ruling 201714008 involved the following facts:

> On Date, a date occurring after 2001, Donor created Trust for the benefit of Brother, Brother's spouse, and Brother's descendants. On the same date, Donor transferred $a to Trust.
>
> Under the trust instrument, Brother has a lifetime and testamentary limited power to appoint trust assets to Brother's spouse or lineal descendants, subject to an ascertainable standard, and the power to appoint trust assets to any charitable organization, but has no power to appoint assets in favor of himself, his estate, his creditors, the creditors of his estate, or to discharge any of his legal obligations.
>
> Under the trust instrument, Brother has a withdrawal power in an amount equal to any contribution to Trust and upon his death, the withdrawal power passes to Brother's spouse. The withdrawal power may not exceed the least of (i) the total amount of contributions to Trust during that year, (ii) the amount allowable at the time of the first contribution as an exclusion from gift tax under § 2503(b)(3) (or twice this amount if the donor is married on the date of the last of all contributions made during that year), and (iii) the greater of $5,000 or 5 percent of the value of Trust. Trust provides that any unexercised right of withdrawal shall lapse at the end of each year or, if earlier, thirty days after the contribution to which it relates.

Counsel advised the donor that the trust was a "GST trust." Later, counsel was not quite sure. Thus, rather than formally electing to treat the trust as a "GST trust" on a gift tax return reporting the first gift to the trust, a pretty painless procedure, the donor instead needed to get an expensive letter ruling. Fortunately, Letter Ruling 201714008 held:

> In this case, Trust is a trust that could have a GST with respect to the transferor. Under the terms of Trust, no provision is made for mandatory distributions to beneficiaries who are non-skip persons. Although Brother is granted a power of appointment over Trust corpus, the power is limited to a certain class of beneficiaries and Brother has no power to appoint assets in favor of himself, his estate, his creditors, the creditors of his estate, or to discharge any of his legal obligations. Although Trust provides withdrawal powers to beneficiaries who are non-skip persons, since the amount of the annual withdrawal rights in Trust do not exceed the amount referred to in § 2503(b), the amount subject to the withdrawal right shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal pursuant to § 2632(c)(3)(B). Furthermore, the withdrawal rights lapse each year in their entirety. Accordingly, based on the facts submitted and the representations made, we conclude that none of the

Restructuring trusts might or might not have tax consequences. The discussion in the rest of this part III.B.1.b is subject to the idea that any person, who is a remainderman in default of the exercise of a power of appointment and is not a current permissible distributee, appears not to have an interest in any modification that affects only current trust administration and therefore would not make a gift upon any such modification.[5947]

Suppose a trust includes a power that would cause estate inclusion and a court modifies the trust (not a retroactive clarification,[5948] but rather a prospective modification). Although the modification itself might have transfer tax consequences, if the modification is legally binding then the IRS will respect its subsequent effect – even if inconsistent with what the highest court

> exceptions to the definition of a "GST trust" in § 2632(c)(3)(B) apply. Therefore, on the date of Donor's Transfer to Trust, Trust was considered a "GST trust" under § 2632(c)(3)(B) and, accordingly, we conclude that Donor's available GST exemption was automatically allocated to the transfer to Trust on Date pursuant to § 2632(c)(1).

[5947] See fn 1975 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

[5948] Letter Ruling 201652002 approved reforming a GRAT to include required language. Florida Trust Code § 736.0416, which corresponds to Uniform Trust Code § 416, authorized the action. The GRAT's savings clause probably helped a lot in terms of making the court action a retroactive reformation clarify the original intent rather than a prospective modification:

> In this case, each trust instrument provides that Grantor's retained interest is intended to constitute a qualified interest within the meaning of § 2702(b)(1). However, the attorney retained to draft each trust instrument failed to include in each instrument the prohibition required by § 25.2702-3(d)(6) thus causing the interest Grantor retained in each Trust to fail to constitute a qualified interest within the meaning of § 2702(b)(1). The trust instruments and State Statute permit the amendment of each Trust.
>
> Accordingly, based on the facts submitted and the representations made, we conclude that as a result of the judicial reformation of Trusts to correct scrivener's error, Grantor's interest in each Trust is a qualified interest under §§ 25.2702-2 and 25.2702-3, effective as of the date each Trust was created.

For comments from the ACTEC Fellow who obtained the ruling, see Thompson Coburn LLP document number 6488460.

in the state would have done.[5949] However, the IRS sometimes conflates the two concepts, as it did in CCA 201747005.[5950]

Failing to enforce one's legal rights might constitute a gift.[5951] Providing background to Rev. Rul. 81-264, one of the rulings cited in fn 5951, GCM 38584 reasoned:

[5949] Rev. Rul. 73-142 held:

> In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, regardless of how erroneous the court's application of the state law may have been. Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.
>
> Unlike the situation in *Bosch*, the decree in this case was handed down before the time of the event giving rise to the tax (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such date since the decree, in and of itself, effectively extinguished the power. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter.
>
> Accordingly, it is held that the value of the property transferred to the inter vivos trust is not includible in the grantor-decedent's gross estate under section 2036 or section 2038 of the Code.

[5950] See fn. 2374 in part II.J.4.c Charitable Distributions, looking at the requirement that the governing instrument must authorize a distribution to charity for the trust to take the Code § 642(c) charitable deduction.

[5951] Rev. Rul. 84-105 held that the surviving spouse made a gift by failing to object to underfunding of a general power of appointment marital deduction trust for her benefit over which she appeared to have an unlimited withdrawal right:

> In the present case, S could have recovered the [shortfall] by routinely asserting in the local probate court the right as beneficiary under D's will to have the bequest adequately satisfied. The fact that some of the land would have had to be either sold or severed to satisfy fully the bequest to S would not have impaired S's claim for full satisfaction. The failure of S to raise an objection to the underfunding of the testamentary trust at some time before the expiration of S's right to appeal the final order of the local probate court in effect constituted an irrevocable transfer to C by S of the 40x dollar amount.
>
> S's acquiescence in the underfunding of the trust is not an assignment or surrender of a property interest in settlement of a controversy described in section 20.2056(e)-2(d)(1) of the regulations. Further, S's acquiescence is not a qualified disclaimer because S made no disclaimer of the 40x dollar amount within 9 months of D's death.
>
> For purposes of the estate and gift tax provisions of the Code, the amount of property that passed from D to S under D's will was [the full amount of the bequest shown on the estate tax return], notwithstanding the underfunding of S's trust. The [shortfall] that was diverted by D's executor from S to C is a gift by S to C on [the expiration date of S's right to appeal the probate court's approval of the estate settlement].

Rev. Rul. 81-264 held that D made a gift to A by failing to enforce A's note payable to D:

> Here, as in all such familial transactions, there is a presumption that the transfer of wealth from D to A without consideration is not entirely free of donative intent. *Estate of Lang v. Commissioner*, 64 T.C. 404 (1975), *aff'd*, 613 F.2d 770 (9th Cir. 1980). A had the resources to pay the debt, and, as D's child, was the natural object of D's bounty. On these facts, D's failing to enforce the debt obligation and permitting it to be barred by the statute has not been shown to be free of donative intent, and thus is not a transaction in the ordinary course of business within the meaning of section 25.2512-8 of the regulations.

We generally agree with the conclusion of the proposed revenue ruling that D makes a gift to A upon the expiration of the statute of limitations. *Estate of Lang v. Commissioner*, 64 T.C. 404 (1975), *aff'd*, 613 F.2d 770 (9th Cir. 1980). In *Lang*, the Service asserted a gift tax deficiency based upon the lapse of the statute of limitations on the collection of certain loans made by Mrs. Lang to her son. The Tax Court, finding that the petitioner had not overcome the presumption of correctness of the respondent's determination that taxable gifts were made upon the expiration of the statute, sustained the Commissioner. The court noted that donative intent on the part of Mrs. Lang was irrelevant to the determination that a gift had been made[1] and that Mrs. Lang was presumed to know that the statute had run.

[1] *See Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945), Treas. Reg. § 25.2511-1(g)(1).

The Ninth Circuit, in affirming the Tax Court decision, analyzed the transfer of property necessary to an imposition of a gift tax in the following manner.

> The running of the statute of limitations, however, accomplishes much more than the taxpayer suggests. It serves to transfer control of a debt to the debtor at the end of the statutory period. Thereafter, it is the debtor rather than the creditor who decides whether and under what terms loaned funds will be repaid. *Cf. Smith v. Shaughnessy*, 318 U.S. 176, 181 (1943) ("The essence of a [taxable] gift by trust is the abandonment of control over the property put in trust ") That control is transferred by a statutory mechanism rather than an overt donative gesture is not significant. "Indirect" gifts are as subject to the gift tax as are "direct" gifts. I.R.C. § 2511(a); Treas. Reg. § 25.2511-1(c) (1958). *Estate of Lang*, 613 F.2d at 773.

The Ninth Circuit also noted several factors that supported the presumption of a gift. Mrs. Lang's son had borrowed money from Mrs. Lang on five separate occasions, never repaying any portion of it. Further, Mrs. Lang had expressly forgiven portions of two of the loans, and in her will she forgave the remaining debts of her son, including the loans at issue. Finally, the court noted that the loans were not typical business loans since they bore no interest. Based upon these facts, the court held that the Tax Court did not err in finding that Mrs. Lang had allowed the statute of limitations to run and had thereby implicitly forgiven the debts. Moreover, the court noted that this finding of donative intent was not essential to a finding that a taxable gift had occurred.

Therefore, we generally agree that under the facts in the proposed revenue ruling D will make a gift to A upon the expiration of the statute of limitations on the collection of the loan. We wish to point out, however, that there may be occasions where a taxpayer can successfully argue that the transfer occasioned by the lapse of the statute of limitations was made "in the ordinary course of business' within the meaning of Treas. Reg. § 25.2512-8 so as to prevent such transfer from being classified a gift. Treas. Reg. § 25.2512-8 provides in relevant part as follows:

It does not matter that the running of the statute of limitations does not extinguish the debt but merely creates an affirmative defense in a collection suit. Control of the debt passes to the debtor when the statute of limitations runs. Thereafter, it is the debtor rather than the creditor who decides whether and under what terms loaned funds will be repaid. The essence of a gift is such relinquishment of control by the donor over the property. *Estate of Lang v. Commissioner*.

> § 25.2512-8 *Transfers for insufficient consideration*. Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth….

Although not articulated with any precision by either the Tax Court or the Ninth Circuit, this concern that certain transfers occasioned by the lapse of the statute of limitations might not be gifts is evident in both opinions. The Tax Court flatly stated:

> We do not thereby imply that in all circumstances the mere running of the statute of limitations on a loan constitutes a gift for gift tax purposes. We merely hold that under the circumstances of this case, we cannot rule that petitioner has carried its burden of proof to the contrary. *Estate of Lang*, 64 T.C. at 413.

The Ninth Circuit specifically noted that the loans by Mrs. Lang to her son "were not typical business loans, for they bore no interest " 613 F.2d at 773. Interestingly, in answering the petitioner's assertion that, because Mrs. Lang had died, it had no way of proving she did not intend to allow the statute to run, the Ninth Circuit stated in a footnote that petitioner might have had other parties testify whether Mrs. Lang ever made informal attempts to collect the debts. Since the court, as discussed above, also noted that donative intent was irrelevant, its discussion of methods for proving intent in the footnote can be construed as relating to the limited exception for transfers made "in the ordinary course of business."

Intrafamily transactions are of course subject to great scrutiny and will create the presumption of a gift. *Heringer v. Commissioner*, 235 F.2d 149, 151 (9th Cir. 1956). Both the courts and the Service have recognized, however, that bona fide, arm's length transfers between family members or related persons may be for an adequate consideration in money or money's worth in certain circumstances and therefore not be taxable gifts. *See, e.g.*, *Beveridge v. Commissioner*, 10 T.C. 915 (1948), *acq.*, 1949-1 C.B. 1; *Estate of Friedman v. Commissioner*, 40 T.C. 714 (1963), *acq.*, 1964-1 (Part 1) C.B. 4; *Estate of Messing v. Commissioner*, 48 T.C. 502 (1967), *acq.*, 1968-1 C.B. 2; G.C.M. 33351, … I-2255 (Oct. 13, 1966). O.M. 19249, … I-95-80 (May 9, 1980).

Under the facts in the proposed revenue ruling, D's loan to A , unlike the situation in Lang, was evidenced by a legally enforceable promissory note with interest payable at the market rate. Although D and A initially intended the note to be enforceable, A failed to repay it upon maturity even though A had "some financial resources" Based upon these facts, the ruling concludes that D made a gift to A upon the expiration of the statute of limitations. We believe that D might under certain circumstances be able to convince a court that the transfer occasioned by the lapse of the statute of limitations was made "in the ordinary course of business." For example, suppose that the loan to A had been for use in A's sole proprietorship. Although A had some business and personal assets, D's collection of the loan would have bankrupted the business, leaving D with a net recovery after court costs of far less than the money loaned. D decided not to sue for collection because he believed that the prospects of eventual full recovery on the note were good. D fully intended to eventually recover all the money loaned. Under such circumstances, D may be able to convince a court that the transfer occasioned by the lapse of the statute was made "in the ordinary course of business."

We emphasize that we are not suggesting the Service should necessarily accept a taxpayer's contentions in this regard, for the evidence produced may well be self-serving. As discussed above, intrafamily transactions create the presumption of a gift. We only wish to note that where a transferor like D is able to show that the statute of limitations lapsed under circumstances similar to those outlined above, we believe a court might find that no taxable gift has occurred.[2]

[2] We express no opinion on whether D would be allowed a bad debt deduction if the debt became worthless under such circumstances. Courts have often treated advances by parents to their children as gifts rather than true debts for income tax purposes. *See*, *e.g.*, *Grossman v. Commissioner*, 9 B.T.A. 643 (1927); *Davidson v. Commissioner*, 37 T.C.M. 725 (1978). When courts have found a true indebtedness to exist, however, they have sometimes allowed bad debt deductions. See, *e.g.*, *Estate of Ames v. Commissioner*, 5 T.C.M. 73 (1946); *Walsh v. Commissioner*, 313 F.2d 389 (4th Cir. 1963). Of course, the debt must generally be worthless for a deduction to be allowed, and courts have sometimes found taxpayer's proof of worthlessness insufficient when no efforts to collect on loans to family members have been made. *See*, *e.g.*, *Griffiths v. Commissioner*, 70 F.2d 946 (7th Cir. 1934); *Acheson v. Commissioner*, 155 F.2d 369 (5th Cir. 1946). We likewise express no opinion on whether a deduction for non-business bad debts would be allowed in view of the limitations on deductibility under section 267 of the Code.

We recognize that the proposed revenue ruling should not be a roadmap for taxpayer avoidance. We therefore feel that it is unnecessary to highlight the "ordinary course of business' exception through an extended discussion of its potential application to the facts in the proposed ruling. We believe that the reference to Treas. Reg. § 25.2512-8 in the analysis section of the proposed ruling is sufficient to acknowledge the existence of an exception to the general rule.[3]

[3] Our concern that certain transfers occasioned by the lapse of the statute of limitations might be "in the ordinary course of business' in no way affects the rationale or conclusion in Rev. Rul. 77-299, 1977-2 C.B. 343, considered by this office in G.C.M. 36356 …, I-216-75 (Aug. 4, 1975). As the proposed revenue ruling notes, Rev. Rul. 77-299 held that the intent to forgive promissory notes at the inception of a "loan" rendered such notes illusory consideration; hence, the transfer was not made for an adequate consideration in money or money's worth, and a gift was made of the loan proceeds. Under the proposed revenue ruling, the note given by A to D was intended to be enforceable. Consequently, there was consideration at the loan's inception.

Finally, we have revised the facts of the proposed revenue ruling to indicate that the statute of limitations on the collection of the interest expired at the same time as the statute of limitations on the collection of the principal. While the general rule with respect to installment payments of interest due before the maturity of the principal debt is that the statute of limitations does not begin to run until the principal debt is due and payable,[4] in certain jurisdictions the statute begins to run against each installment when it becomes payable.[5] To avoid unnecessary confusion and to provide simplicity of result,

> we have therefore made the above-mentioned factual revision. Consequently, the amount of the gift will equal the unpaid balance of the principal plus accrued interest.
>
> [4] See Annot., 36 A.L.R. 1085 (1925).
>
> [5] Annot., 36 A.L.R. 1085 (1925), *supra* n.4; *See*, *e.g.*, *Fuller v. White*, 33 Cal.2d 236, 201 P.2d 16 (1949) (interpreting Cal. Code Civ. Proc. § 337).
>
> A revised proposed ruling incorporating this suggested change is attached for your consideration.

Thus, the trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile them together, which procedure might help minimize any gift tax consequences to failing to make a claim.[5952]

If a beneficiary exercises his inter vivos limited power of appointment in a manner that moves all of the trust's assets elsewhere, the beneficiary has made a gift of the beneficiary's interest in the trust,[5953] even though Code § 2514 itself does not capture the exercise as a gift.[5954] Letter

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[5952] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.

[5953] Reg. § 25.2514-1(b)(2), which provides:

> The power of the owner of a property interest already possessed by him to dispose of his interest, and nothing more, is not a power of appointment, and the interest is includible in the amount of his gifts to the extent it would be includible under section 511 or other provisions of the Internal Revenue Code. For example, if a trust created by provides for payment of the income to A for life with power in A to appoint the entire trust property by deed during her lifetime to a class consisting of her children, and a further power to dispose of the entire corpus by will to anyone, including her estate, and A exercises the inter vivos power in favor of her children, she has necessarily made a transfer of her income interest which constitutes a taxable gift under section 2511(a), without regard to section 2514.

Letter Ruling 9451049 held that the exercise of an inter vivos limited power of appointment constituted a gift:

> The inter vivos powers held by A and B to direct distributions to the descendants of the decedent cannot be exercised to benefit the possessor of the power, her estate or the creditors of either. Consequently, these powers are not general powers of appointment as described under section 2514. Further, the exercise of these powers will not result in the release of any general power possessed by either A or B over trust corpus, as described in section 25.2514-1(b)(2)….
>
> However, A and B have, during their respective lives, the right to periodic distributions of income and principal to provide for health, support and maintenance in the standard of living to which each is accustomed. The proposed exercise by A and B of their respective special powers would constitute a transfer of their interests under section 25.2514-1(b)(2) and section 2511(a). The value of their interests is readily ascertainable. See Rev. Rul. 75-550, 1975-2 C.B. 357. Consequently, A and B's exercise of their respective powers to appoint their respective trust estates to each other constitutes a transfer of their respective beneficial interests in each trust. See section 25.2514-1(b)(2). Each transfer would constitute a taxable gift under section 2511(a).

Rev. Rul. 75-550 is not directly on point but does explain how to value a beneficial interest for purposes of the Code § 2013 credit for tax on prior transfers.

[5954] Reg. § 25.2514-3(e), Example (3), provides:

> The income is to be paid to L for life. L has a power, exercisable at any time, to cause the corpus to be distributed to himself. L has a general power of appointment over the remainder interest, the release of which constitutes a transfer for gift tax purposes of the remainder interest. If in this

Ruling 200243026 asserted that this rule applies even though any distributions to the beneficiary were in the "sole discretion" of a disinterested trustee.[5955] TAM 9419007 asserted that an inter vivos limited power was tantamount to a general power because the taxpayer had the current right to income and the right to receive all of the principal at age 30.[5956] If and to the

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> example L had a power to cause the corpus to be distributed only to X, L would have a power of appointment which is not a general power of appointment, the exercise or release of which would not constitute a transfer of property for purposes of the gift tax. Although the exercise or release of the nongeneral power is not taxable under this section, see § 25.2514-1(b)(2) for the gift tax consequences of the transfer of the life income interest.

Rev. Rul. 79-327 reasons:

> An income interest and a special power to appoint the underlying property to other persons are separate rights that may be possessed by an individual. If the individual possesses both the special power and the income interest, the exercise of the special power during life results in a gift, for purposes of section 2511, since the individual, by exercising the power, also relinquishes the income interest. See section 25.2514-1(b)(2) of the regulations. But see *Self v. United States*, 142 F.Supp. 939 (Ct. Cl. 1956), where the court reached a contrary conclusion. The Service will not follow *Self* to the extent that it is contrary to the regulations.
>
> Example 3 of section 25.2514-3(e), discussed above, considers only the gift tax consequences of the exercise or release of a special power of appointment and is limited to the application of section 2514 with respect to a transfer of corpus subject to the power. Therefore, Example 3 does not address the section 2511 gift tax consequences of the relinquishment of an income interest. Thus, a release of the special power, permitting the remainder to pass in default of appointment, results in no gift. However, the exercise of the special power terminates the life interest resulting in a gift of that interest under section 2511. See E.T. 23, 1950-1 C.B. 133, declared obsolete in Rev. Rul. 67-97, 1967-1 C.B. 380, setting forth the same position with regard to statutory provisions and regulations under the 1939 Internal Revenue Code substantially similar to those in issue in this case.

[5955] Letter Ruling 200243026 reasoned:

> Pursuant to Trust, Spouse also has interests in the income and principal of Trust. Trust provides that the Disinterested Trustee, in his sole discretion, may distribute to Spouse income and/or principal as the Disinterested Trustee deems necessary or appropriate for the care, support, maintenance, education, advancement of life and comfortable living of Spouse. As a result of Spouse's exercise of his inter vivos special power appointing the Trust corpus to the Child 3 Trust, Grandchild 1 Trust, and Grandchild 2 Trust, Spouse will relinquish his income and corpus interests in Trust. Although Spouse's rights to receive income and principal distributions from Trust are subject to the sole discretion of the Disinterested Trustee, the relinquishment of these interests will be a taxable gift under § 2511(a). See *Estate of Regester*, *supra* and Rev. Rul. 79-327, *supra*. The value of the gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 20, and Rev. Rul. 75-550, 1975-2 C.B. 357 (illustrating the correct method of computing the value of a decedent's interest in a residuary trust subject to the discretionary power of the trustee to invade corpus for the benefit of others).

Further above, the ruling had mentioned:

> *Estate of Regester v. Commissioner*, 83 T.C. 1 (1984) (holding that a decedent made a taxable gift of her life interest in the income of a trust when she transferred the corpus of the trust through the exercise of a special power of appointment).

[5956] The facts were:

> THE CREATION OF THE TRUSTS:
>
> Under the facts as presented, in 1959, the Grantor purportedly created eleven separate trusts for the benefit of the members of the family of M. Each trust had an initial term of 20 years. During the first 15 years of the trust term, income was accumulated. During the next 5 years of the trust term, income was paid for the support of a designated older generation family member.

extent that the transfer is a gift, person exercising the power of appointment becomes the transferor with respect to the gifted portion and may allocate GST exemption to that portion.[5957]

At the end of the 20-year term, each trust was to be held for the benefit of a designated grandchild of N. The principal and accumulated income of each separate trust was distributable to a designated grandchild when he or she reached age 30. If a grandchild died before reaching age 30, the trust property otherwise distributable to him or her was to be distributed instead to his or her issue, or if none, to (or for the benefit of) the other younger generation family members. Between the end of the 20-year trust term and the date that a respective grandchild reached age 30, the income of the separate trust held for that grandchild was payable to him or her. The provision creating this interest states:

> As to any persons designated to receive distributions . . . who shall be under 30 years of age at the end of the 60 month period, instead of making distribution to such person, TRUSTEE SHALL DISTRIBUTE TO SUCH PERSON THE NET INCOME FROM HIS TRUST UNTIL HE ATTAINS THE AGE OF 30, at which time Trustee shall distribute to him all the accumulated income fund, current income and any principal then remaining in his trust. [Emphasis added.]

Under the provisions of each separate trust, each grandchild had a power of appointment, labeled a "Limited Power of Appointment." The power was exercisable at any time during the grandchild's lifetime by written instrument or at death by testamentary instrument. Under the "Limited Power of Appointment," each grandchild could appoint "his interest in the trust estate" to, or in trust for, certain family members. The trust instrument states:

> No power of appointment . . . shall be exercised to any extent in favor of the Donee of such power, his estate or for the benefit of his creditor or the creditors of his estate. . . .

THE DONOR'S EXERCISE OF THE POWER OF APPOINTMENT BEFORE REACHING AGE 30:

The Donor is a grandchild of N and was the designated beneficiary of one of the trusts. Her siblings and cousins were the designated beneficiaries of the other trusts.

The initial 20-year trust term ended in 1979 at which time the grandchildren, including the Donor, became the prime beneficiaries of the trusts. In early 1980, before any of the grandchildren had reached age 30, but after they had all attained their majority, the Donor and the other grandchildren each exercised his or her power to appoint his or her trust interests. Pursuant to a document captioned "Exercise of Limited Power of Appointment" dated February 1980, the Donor directed that her trust interests be distributed to newly created trusts (herein referred to as the Family Trusts) for the benefit of certain other family members. The other grandchildren made similar dispositions.

At the time that the powers of appointment were exercised, the Donor (and each grandchild) possessed: 1) a contingent remainder interest in a trust (which would ripen into absolute ownership of the property upon that grandchild's reaching age 30); and 2) the right to receive current trust income until reaching age 30. The issue presented is whether the Donor made a taxable gift when she exercised the "Limited Power of Appointment," thus relinquishing these interests in favor of the other family members.

[5957] Letter Ruling 200243026 reasoned:

Further, because Spouse will have made a taxable gift of his income and principal interests to the three trusts, Spouse will be considered the transferor of the value of the taxable gift for purposes of chapter 13. The beneficiaries of the Grandchild 1 Trust and Grandchild 2 Trust include Spouse's grandchildren, descendants of the grandchildren or charitable organizations. Therefore, the trust is a skip person. Accordingly, the transfer is a direct skip for purposes of chapter 13. Spouse's GST exemption will be deemed allocated to the property transferred by him to the two trusts, unless Spouse elects not to have § 2632(b) apply. The beneficiaries of the Child 3 Trust include Spouse's child, Child 3, Child 3's spouse, Child 3's issue, spouses of Child 3's issue, and descendants of Child 3. The trust could have a generation-skipping transfer with respect to the transferor, Spouse, and the trust does not come within any exceptions contained in § 2632(c)(3)(B)(i). Therefore, the Child 3 Trust is a GST trust. Accordingly, the transfer is an indirect skip for purposes of chapter 13. Spouse's GST exemption is deemed

Of course, a nonqualified disclaimer of a life estate constitutes a gift of the value of the life estate.[5958]

Another gift might be early termination of a trust. When a beneficiary may receive distributions under an ascertainable standard and has an annual right to withdraw from the trust, the beneficiary made a gift by renouncing distributions to her while living,[5959] caused her to become the transferor for GST purposes to the extent of the property she renounced,[5960] but did not blow

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> allocated to the property transferred by Spouse to the Child 3 Trust, unless Spouse elects not to have § 2632(c) apply. Each portion of the three trusts of which Spouse is the transferor will comprise the chapter 13 portion of each trust. The non-chapter 13 portions and the chapter 13 portions of each trust are treated as separate trusts for purposes of chapter 13. Section 26.2654-1(a)(2)(i).
>
> Accordingly, based upon the facts submitted and representations made, we rule as follows: The proposed exercise of the power of appointment by Spouse and the resulting transfer of the appointed assets of Trust to the two GSETs and the Child 3 Trust will not constitute constructive additions to the Trust under § 26.2601-1(b)(1)(v). The proposed exercise of the power of appointment by Spouse will result in a taxable gift of Spouse's income and principal interests under § 2511. For purposes of chapter 13, Spouse will be the transferor of the gifted property transferred by Spouse to the Child 3 Trust and the two GSETs. The gifted property in each trust will comprise the chapter 13 portion of the trusts. The balance of the corpus of each trust will constitute the non-chapter 13 portion of each trust. Spouse's GST exemption will be deemed allocated to the chapter 13 portions of each trust, unless Spouse elects not to have § 2632(b) and (c) apply. The chapter 13 portion of each trust will have an inclusion ratio determined under § 2642. The non-chapter 13 portions of each trust will be exempt from GST tax under § 26.2601-1(b)(i).

[5958] Letter Ruling 201928003, which the taxpayer requested under Reg. § 25.2512-5(d)(4), held:

> In the present case, Taxpayer disclaimed her life estate interests in three trusts on Date 2. The disclaimer constituted completed gifts to the owners of the remainder interests in the trusts. At the time the gifts were made, Taxpayer had been diagnosed as being terminally ill with at least a fifty percent probability that she would die within one year of Date 2. Taxpayer died on Date 3. Because Taxpayer was terminally ill within the meaning of § 25.7520-3(b)(3) at the time of the Date 2 gifts, the mortality component prescribed under § 7520 for ordinary life estate interests may not be used to determine the present value of the life estate interests disclaimed by Taxpayer on Date 2. Thus, an actuarial factor of .00043 must be used in valuing the gifts.

[5959] Letter Ruling 200745015, reasoning:

> The value of the gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2007-1, 2007-1 I.R.B. 1, 14. However, since the gift is not an absolute right to distributions of income or principal, it cannot be valued by use of the tables contained in § 2512. See *Deal v. Commissioner*, 29 T.C. 730 (1958). Rather, the value of the gift should be determined in accordance with the general valuation principles contained in § 25.2512-1. Further, such an interest has more than a nominal value. See Rev. Rul. 67-370, 1967-1 C.B. 324.

[5960] Letter Ruling 200745015, further explaining (with "exemption" referring to grandfathering from GST tax):

> As stated above, under § 2652, for purposes of chapter 13, Daughter is the transferor of X shares that will be transferred to the three subtrusts. Accordingly, the three subtrusts are not exempt from chapter 13 by virtue of Trust's exemption. Daughter may allocate her GST exemption to the three subtrusts at the time of the transfer or GST exemption may be automatically allocated under § 2632(c)(1) depending on whether the subtrusts are GST Trusts as defined in that Code section. Based upon the facts provided and the representations made, we conclude that Daughter is the transferor of the X shares that will be transferred to the three subtrusts for purposes of chapter 13 and, accordingly, distributions and terminating distributions from the subtrusts to skip persons are subject to GST tax.

GST grandfathering for the remaining property.[5961] Renouncing a testamentary nongeneral power of appointment did not have gift tax consequences or blow GST grandfathering.[5962]

On the other hand, if Mom creates a trust for the benefit of Daughter and Daughter's children, but Daughter doesn't need all of that money and would like her children to benefit currently and cooperates in the trustee's obtaining a court order directing early partial termination of the trust. That action:[5963]

- Is not subject to income tax,[5964]
- Will not blow the trust's grandfathering from generation-skipping transfer tax,[5965] and

[5961] Letter Ruling 200745015, reasoning:

Trust was executed prior to September 25, 1985, and it is represented that there have been no additions (actual or constructive) to Trust since that date. Accordingly, Trust is not subject to chapter 13. Daughter's renunciation of her entire beneficial interest in X shares is a taxable transfer for gift tax purposes. X shares will be transferred into three subtrusts in which Daughter will have no interest. The property remaining in Trust continues to be subject to the original Trust provisions, with no modifications to those provisions. Based upon the facts provided and the representations made, we conclude that Daughter's renunciation of her entire beneficial interest in X shares will not cause Trust to become subject to chapter 13.

[5962] Letter Ruling 200745015, reasoning:

As discussed above, Daughter holds a testamentary nongeneral power of appointment over Trust. Daughter will release this power over X shares that are transferred to the three subtrusts. The power of appointment was created in Trust, an irrevocable Trust, that is not subject to chapter 13. Therefore, the release of the power of appointment over X shares will not be treated as a constructive addition to Trust. Accordingly, based upon the facts provided and the representations made, we conclude that the release of Daughter's testamentary nongeneral power of appointment over X shares will not cause Trust to become subject to chapter 13.

[5963] Per Letter Ruling 201122007, parts of which are quoted in the footnotes below.

[5964] Letter Ruling 201122007, which did not appear to involve any debt, concluded Ruling 1 by reasoning:

In general, a gift or other transfer without reciprocal consideration is not treated as a sale or exchange or as a distribution of property that results in a realization of income by the donor. *See, e.g.*, § 1.1001-1(e) (illustrating that the gift portion of a transfer is not treated as gain realized). The same would be true of a transfer from a trust as provided in the terms of the trust agreement or by court order modifying the trust agreement. Such a transaction is not a realization event in which property differing in kind or extent is being exchanged. In addition, gross income does not include the value of property acquired by gift, bequest, devise or inheritance. See § 102.

Based on the information submitted, Taxpayer, the remainder beneficiaries, and Trust will not recognize gain as a result of the early distribution of a portion of the trust principal to the remainder beneficiaries because the distribution will not constitute a sale, exchange, or other realization event. Also, there is no accession of wealth to Taxpayer or Trust. In addition, to the extent that any portion of the early distribution of the trust principal and accumulated income (previously taxed to the trust) constitutes a gift, bequest, devise or inheritance to the remainder beneficiaries, it will not constitute includable income to the remainder beneficiaries for federal income tax purposes because of the exclusion provided under § 102.

[5965] Letter Ruling 201122007 concluded Ruling 2 by reasoning:

State Statue provides that a noncharitable irrevocable trust may be modified on consent of all the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust.

Based on the facts presented and representations made, we conclude that if State court issues an order approving the early distribution of a portion of the trust principal to the remainder beneficiaries, as discussed above, this distribution will not shift any beneficial interest in Trust to a

- Will constitute a gift by Daughter, albeit perhaps a nominal gift.[5966]

Rev. Rul. 67-370 is somewhat disturbing, in that one needs to impose survivorship as a condition precedent to prevent inclusion in an outright remainderman's gross estate. It starts:

> Advice has been requested whether a certain remainder interest in trust which may be terminated at the will of another is an interest in property within the meaning of section 2033 of the Internal Revenue Code of 1954.
>
> Under the terms of an inter vivos trust, controlled by New York law, the decedent or his estate was to receive the principal upon the death of the settlor. The settlor had reserved the right to modify, alter, or revoke the trust during her lifetime. Subsequent to the decedent's death, the settlor modified the trust and extinguished the estate's defeasible remainder interest.

After reciting Code § 2033 and Reg. § 20.2033-1(a), the IRS reasoned:

> Where a decedent's right to receive benefits under a trust is so conditioned as to terminate at his death, such interest does not constitute an includible interest in property for the purpose of section 2033 of the Code. Revenue Ruling 55-438, C.B. 1955-2, 601. A contrary result will naturally obtain, however, in case the decedent owns any beneficial interest in a trust which survives his death, whether or not such interest is subject to being lawfully curtailed or cut off at any time thereafter. The decedent's interest in the trust involved in the subject case is thus an includible interest. It was clearly "descendible, devisable, and alienable" as a matter of New York law, for example, and would undoubtedly have resulted in the receipt of substantial assets by decedent's estate if the settlor had not proceeded to revoke the same. *In re: Horn-blower's Estate*, 180 N.Y. Misc. 517, 40 N.Y.S.2d 712 (1943).

> beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. In addition, the early distribution of a portion of the trust principal to the remainder beneficiaries will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. Accordingly, based on the facts submitted and the representations made, we conclude that if, under a State court order, the trustees of Trust make an early distribution of the trust principal to the remainder beneficiaries, such a distribution will not cause Trust to be subject to the generation-skipping transfer tax imposed by chapter 13.

[5966] Letter Ruling 201122007 concluded Ruling 3 by reasoning:

> Taxpayer attests that Taxpayer has never received a distribution from Trust and that her income and resources are sufficient to maintain her current standard of living for the remainder of her lifetime. However, that does not negate the fact that under Section 6(a) of Trust, Taxpayer has an income interest entitling her to distributions of income in the case of emergency and at the discretion of the trustee. The interest may be nominal, however, the value of the gifted interest is a factual determination, not a determination of whether or not Taxpayer has made a gift of the interest.
>
> Based upon the facts submitted and representations made, we conclude that Taxpayer will make a gift of her interest in the portion of the early distribution of the trust principal to the remainder beneficiaries. The value of this gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2011-1, 2011-1 I.R.B. 1, 13.

Note that the IRS might argue that the value of Taxpayer's gift in Letter Ruling 201122007 is the value of Taxpayer's entire interest in the trust. See part Code § 2702 Overview, especially the text accompanying fns. 6851-6858.

> In providing that the value of the gross estate shall include the value of "all" property to the extent of the interest therein of the decedent at the time of his death, section 2033 is not affected by formal legal distinctions of nomenclature under state law. Therefore, it is not relevant to the application of section 2033 that a particular interest in property which survives the decedent's death may be either defeasible or indefeasible.
>
> Any determination of what would be the fair market value of a particular remainder interest like that under consideration herein would be affected by its possible curtailment or complete divestment at some point after decedent's death, in accordance with the general rules for the valuation of property which are set forth in section 20.2031-1(b) of the Estate Tax Regulations. See *Estate of Waldo G. Bryant v. Commissioner*, 36 B.T.A. 669 (1937), *affirmed* 104 F.2d 1011 (1939), *affirmed sub nom. Helvering v. Hallock*, 309 U.S. 106 (1940), Ct. D. 1440, C.B. 1940-1, 223. See also *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943), Ct. D. 1575, C.B. 1943, 1144. The mere presence of these possibilities does not warrant the assignment of a merely nominal value to such a defeasible interest in any case where there is still a reasonable probability that the estate will actually acquire possession of at least some substantial portion of the property in question. See *In re: Hornblower's Estate*, above.
>
> It is accordingly held that if a defeasible interest in property survives the decedent's death, its fair market value is includible in the decedent's gross estate.

To avoid this result, consider always requiring survivorship as a condition preceding to the remainderman taking outright. Leaving the remainder in trust may also help. We tend to suggest that a remainderman's interest being subject to the primary beneficiary's power of appointment may make any diminishment of the remainderman's interest not constitute more than a nominal gift, but the precautions stated above in this paragraph may be important to implement to support that suggestion.

Other authority related to valuing a gift diminishing a discretionary interest includes:[5967]

> Rev. Rul. 67-370. *Cf. Snyder v. Comm'r*, T.C. Memo. 1989-529. (holding that the value of a gift of common stock prior to the enactment of chapter 14 of the Code could be discounted in order to reflect the rights of preferred shareholders' put rights). *See* Rev. Rul. 75-550 (valuing an income interest at a discount to reflect all possible invasions of principal). *See*, *e.g.*, PLR 8535020 (May 30, 1985) ("The fact that the trustee has discretion regarding distributions of income and principal to you is a factor that must be taken into account in determining the fair market value of your beneficial interest"). *See also* PLR 8824025 (June 17, 1988) (the value of discretionary interest in principal appears "negligible" where no distributions had been made); PLR 8905035 (Nov. 4, 1988) (the value of a discretionary interest is to be valued under general valuation principles); PLR 9451049 (Sept. 22, 1994) (the value of the right to distributions for support "is readily ascertainable"); PLR 9714030 (Jan. 7, 1997) (the value of discretionary interest is to be valued under general valuation principles); PLR 9802031 (Oct. 14, 1997) (the value of discretionary support interest "is determined based on all relevant factors, such as the projected needs of [the beneficiary] for health, education,

[5967] Bramwell & Weissbart, "The Dueling Transferors Problem in Generation-Skipping Transfer Taxation," ACTEC Law Journal, Vol. 1, No. 1 (Spring 2015), 95, 109 (fns 37-39), saved as Thompson Coburn LLP doc. no. 7289312.

support, and maintenance for the remainder of his life"); PLR 9811044 (Dec. 11, 1997) (the value of discretionary interest is to be valued under general valuation principles); PLR 199908060 (Dec. 2, 1998) (discretionary interests "have some value, however minimal"); PLR 200243026 (July 24, 2002) (the value of interest subject to discretion of trustee is a question of fact); PLR 200339021 (June 19, 2003) (the value of a contingent support interest is a question of fact); PLR 200745015 (June 6, 2007) (a discretionary interest has "more than a nominal value"); PLR 200745016 (June 8, 2007) (a discretionary interest has "more than a nominal value"); PLR 201122007 (Feb. 24, 2011) (a discretionary interest where no distributions received may be "merely nominal"); PLR 201342001 (July 22, 2013) (expressing no opinion on the value of discretionary interests).

Letter Ruling 201647001 held that the children did not make a gift when a trust was modified to add a clause authorizing an independent trustee to reimburse the grantor's income tax, because the reimbursement clause was "administrative in nature" and did not "result in a change in beneficial interests" in the trust.[5968] Neither that change nor any other change done at the same time had any income, gift, estate, or GST tax consequences.

As alluded to above, many of the gifts raised in this part III.B.1.b involve complex gift tax issues, which may spill over into the GST arena. See part III.B.1.d Generation-Skipping Transfer (GST) Issues.

In the employment arena, some employee benefits to family members may not be considered gifts,[5969] whereas others may be.[5970]

III.B.1.c. Gifts with Consideration – Bargain Sales

Where a transfer of property is in part a sale and in part a gift (a "bargain sale"), the donor has gain to the extent that the amount realized by the donor exceeds the donor's adjusted basis in the property.[5971] However, a donor may not deduct a loss in a bargain sale.[5972]

A bargain sale includes transferring property subject to a debt.[5973] For treatment of interest expense when a partnership interest that carries with it an allocation of partnership debt, see part II.C.3.d Deducting Interest Expense.[5974]

Examples of computing gain or gift when property is transferred in bargain sale:[5975]

5968 To place this in context, see part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner, which discusses this ruling in fn 6492. Note that a gratuitous payment of another person's obligation constitutes a (possibly excludible) gift by the payor, followed by a (possibly deductible) payment by the obligor. *Lang v. Commissioner*, T.C. Memo. 2010-286 (donor's gifts were not taxable; obligor could deduct medical and tax payments).
5969 See fn 3474 in part II.M.4.g Options to Acquire Equity (Stock Options, etc.).
5970 See part II.Q.4.f Split-Dollar Arrangements.
5971 Reg. § 1.1001-1(e)(1).
5972 Reg. § 1.1001-1(e)(1).
5973 See fn. 6158, found in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.
5974 Especially the text accompanying fns 442-444.
5975 Reg. § 1.1001-1(e)(2).

Example (1). A transfers property to his son for $60,000. Such property in the hands of A has an adjusted basis of $30,000 (and a fair market value of $90,000). A's gain is $30,000, the excess of $*60*,000, the amount realized, over the adjusted basis, $30,000. He has made a gift of $30,000, the excess of $90,000, the fair market value, over the amount realized, $60,000.

Example (2). A transfers property to his son for $30,000. Such property in the hands of A has an adjusted basis of $60,000 (and a fair market value of $90,000). A has no gain or loss, and has made a gift of $60,000, the excess of $90,000, the fair market value, over the amount realized, $30,000.

Example (3). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $30,000 (and a fair market value of $60,000). A has no gain and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Example (4). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $90,000 (and a fair market value of $60,000). A has sustained no loss, and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Examples of computing basis in property transferred in bargain sale include:[5976]

Example (1). If A transfers property to his son for $30,000, and such property at the time of the transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $30,000.

Example (2). If A transfers property to his son for $60,000, and such property at the time of transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (3). If A transfers property to his son for $30,000, and such property at the time of transfer has an adjusted basis in A's hands of $60,000 (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (4). If A transfers property to his son for $30,000 and such property at the time of transfer has an adjusted basis of $90,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property by the son its unadjusted basis in his hands is $60,000.

For gift tax purposes, Code § 7872 applies when valuing notes the buyer issues in a bargain sale.[5977]

[5976] Reg. § 1.1015-4(b).
[5977] See fn. 6564 in part III.B.5.a Promissory Notes.

III.B.1.d. Generation-Skipping Transfer (GST) Issues

These materials do not attempt to cover GST issues generally but rather cover selected matters that I feel like documenting.

An addition to a grandfathered trust causes the trust to lose its exclusion from the GST system to the extent of the addition.[5978]

Important scholarship on who is the transferor, particularly when one beneficiary is deemed to have made a gift to other beneficiaries of all or part of the deemed donor-beneficiary's interest in a trust, is cited in fn 5967 in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts. Part III.B.1.b includes some rulings relating to GST issues.

A constructive addition is treated as an addition.[5979] Constructive additions include certain powers of appointment[5980] (if and to the extent the regulation is valid) to the extent not excluded[5981] and the relief of certain liabilities.[5982] Except to the extent that the above rules

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[5978] Reg. § 26.2601-1(b)(1)(iv) provides:

> *In general*. If an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of paragraph (b)(1) of this section, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in section 2642(a)). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in section 2642(a)(2)) for the non-chapter 13 portion is deemed to be 1 and the inclusion ratio for such portion is 0. The chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under section 2642. This paragraph (b)(1)(iv)(A) requires separate portions of one trust only for purposes of determining inclusion ratios. For purposes of chapter 13, a constructive addition under paragraph (b)(1)(v) of this section is treated as an addition. See paragraph (b)(4) of this section for exceptions to the additions rule of this paragraph (b)(1)(iv). See § 26.2654-1(a)(2) for rules treating additions to a trust by an individual other than the initial transferor as a separate trust for purposes of chapter 13.

[5979] See the highlighted portion of Reg. § 26.2601-1(b)(1)(iv) in fn. 5978.

[5980] Reg. § 26.2601-1(b)(1)(v)(A) provides:

> *Powers of appointment*. Except as provided in paragraph (b)(1)(v)(B) of this section, where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12. See section 26.2652-1 for rules for determining the identity of the transferor of property for purposes of chapter 13.

[5981] Reg. § 26.2601-1(b)(1)(v)(B) provides:

> *Special rule for certain powers of appointment*. The release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in section 2041(b)) is not treated as an addition to a trust if—
>
> (1) Such power of appointment was created in an irrevocable trust that is not subject to chapter 13 under paragraph (b)(1) of this section; and

allocate subsequent appreciation and accumulated income between the original trust and additions thereto, appreciation the trust's value and accumulated income are not considered an addition to the principal of a trust.[5983]

Reg. § 26.2601-1(b)(4) sets forth safe harbors for when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust will not cause the trust to lose its grandfathered status. These safe harbors apply to certain discretionary powers, [5984]

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(2) In the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation (the perpetuities period). For purposes of this paragraph (b)(1)(v)(B)(2), the exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership or the power of alienation beyond the perpetuities period. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

[5982] Reg. § 26.2601-1(b)(1)(v)(C) provides:

Constructive addition if liability is not paid out of trust principal. Where a trust described in paragraph (b)(1) of this section is relieved of any liability properly payable out of the assets of such trust, the person or entity who actually satisfies the liability is considered to have made a constructive addition to the trust in an amount equal to the liability. The constructive addition occurs when the trust is relieved of liability (*e.g.*, when the right of recovery is no longer enforceable). But see section 26.2652-1(a)(3) for rules involving the application of section 2207A in the case of an election under section 2652(a)(3).

[5983] Reg. § 26.2601-1(b)(1)(vi).

[5984] Reg. § 26.2601-1(b)(4)(i)(A) provides:

The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13, if—

(1) Either—

(i) The terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or

(ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and

(2) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

settlements,[5985] judicial constructions,[5986] or certain modifications.[5987] Reg. § 26.2601-1(b)(4)(i)(E) provides examples of these safe harbors.

Not satisfying the safe harbors means only that one must test for actual or constructive additions. When a court or trustee takes action (or a trustee fails to act), that action might affect beneficial interests. One may be concerned that failure to act vigorously in court or to make a claim against the trustee may constitute an actual or constructive addition. The beneficiaries

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[5985] Reg. § 26.2601-1(b)(4)(i)(B) provides:

> A court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause the new or continuing trust to be subject to the provisions of chapter 13, if—
>
> (1) The settlement is the product of arm's length negotiations; and
>
> (2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

[5986] Reg. § 26.2601-1(b)(4)(i)(C) provides:

> judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause the new or continuing trust to be subject to the provisions of chapter 13, if—
>
> (1) The judicial action involves a bona fide issue; and
>
> (2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

[5987] Reg. § 26.2601-1(b)(4)(i)(D) provides:

> (1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.
>
> (2) For purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

who failed to act may need to allocate GST exemption to provide a zero inclusion ratio to the extent that they are transferors. These issues become much more complex when a beneficiary has a retained interest in the trust, because the ETIP rules may prevent allocating GST exemption in a manner that sets the inclusion ratio until the beneficiary's interest terminates. Thus, satisfying the safe harbors avoids addressing these issues to the extent that one is concerned about GST issues; however, the safe harbors do not address gift or estate tax issues that might apply to such a failure to act. Regarding the latter, see part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts.

III.B.1.e. Valuation Issues

Business that are not publicly traded are inherently difficult to value.

Corporations that engage in a Code § 162 trade or business are likely to be valued based on their projected net cash flow, with earlier years' results being used to determine whether projected earnings are reasonable.

See part III.C Fairness Within Families; Valuation, for a further discussion of valuation.

Among IRS resources is http://www.irs.gov/Businesses/Valuation-of-Assets, which includes separate papers on discounts for lack of marketability and S corporations.