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Transfer-for-value rule, trust modifications, and Code § 199A safe harbor for rental real estate

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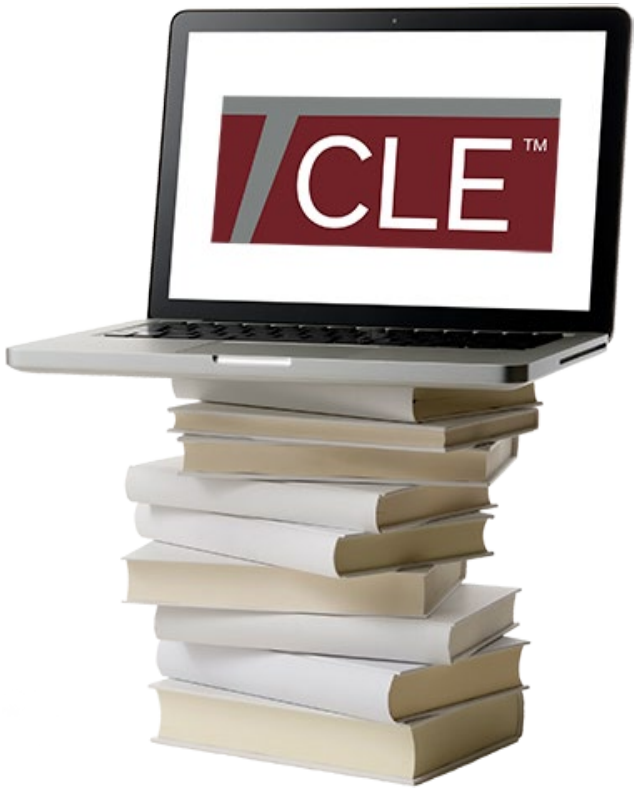

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Overview

- Transfer-for-value rule and trust modifications from webinar 1/28/2020
- Code § 199A safe harbor for rental real estate from webinar 10/29/2019

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Transfer for Value Rule (II.Q.4.b.)

- Code § 101(a)(2) - transfer for a valuable consideration loses Code § 101(a)(1) exclusion
- Exceptions
  - Substituted basis transfer
  - Transfer to permitted transferee
- Look to the deemed owner of a grantor trust when applying this rule. Rev. Rul. 2007-13

Regulations Under the Transfer-for-Value Rule (II.Q.4.b.i.)

Transfer for a valuable consideration

- Former Reg. § 1.101-1(b)(4) - any value will do
- Letter Ruling 7734048 - buy-sell agreement was sufficient consideration to implicate this rule
- New Reg. § 1.101-1(f)(5) – "any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value"
- New 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) – as a transfer for valuable consideration

Transfer for Value Rule (II.Q.4.b.)

Substituted basis transfer – "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"

- Gift
- Transfer to partnership
- Code § 1035 exchange

Transfer for Value Rule (II.Q.4.b.)

Transfer to permitted transferee

- the insured
- a partner of the insured
- a partnership in which the insured is a partner
- a corporation in which the insured is a shareholder or officer

Effect of 2017 Tax Reform on Life Insurance (II.Q.4.b.)

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- Retroactively invalidated Rev. Rul. 2009-13 (regarding basis of policy when sold)
- Reportable policy sale
  - Code § 101(a)(3) changes tax consequence to stranger-owned policies
  - Code § 6050Y reporting requirements
  - regulations finalized October 31, 2019 affect transfer-for-value rules beyond just reportable policy sales

Regulations Under the Transfer-for-Value Rule (II.Q.4.b.ii.)

Reportable Policy Sale - Consequences

- The exceptions to the transfer for value rule under Code § 101(a)(2)(A) or (B) do not apply
- Thus, the death benefit may be taxable, in that the amount excluded from gross income cannot 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
- Various reporting requirements apply when the death benefit is paid

Regulations Under the Transfer-for-Value Rule (II.Q.4.b.ii.)

Reportable Policy Sale – Reg. § 1.101-1(c)

- Code § 101(a)(3)(B) (emphasis added): "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."
- Reg. § 1.101-1(e)(3): "Indirectly" is "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."
- Reg. § 1.101-1(d) describes substantial family, business, or financial relationships
- Discuss relationships then circle back to "indirectly," etc.

Reg. § 1.101-1(d)(3) "Family Member" (II.Q.4.b.ii.(b))

- The individual
- 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
- Any parent, grandparent, or great-grandparent of the individual or of the person described above 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

Reg. § 1.101-1(d)(3) "Family Member" (II.Q.4.b.ii.(b))

- Any lineal descendant of any person described on prior slide
- Any spouse of a lineal descendant described in prior bullet point 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
- Any lineal descendant of a person described in prior bullet point

Reg. § 1.101-1(d)(2) "Substantial Business Relationship" (II.Q.4.b.ii.(b))

- The insured is a key person (as defined in Code § 264) of, or materially participates (within the meaning of Code § 469) 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
- Under Code § 264, 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 (II.Q.4.a.)

Reg. § 1.101-1(d)(2) "Substantial Business Relationship" (II.Q.4.b.ii.(b))

- 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 the insured is in a certain category (next slide), and
- 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

Reg. § 1.101-1(d)(2) "Substantial Business Relationship" (II.Q.4.b.ii.(b))

For the prior slide to apply, the test requires that the insured:

- Is an employee within the meaning of Code § 101(j)(5)(A) of the acquired trade or business immediately preceding the acquisition; or
- Was a director, highly compensated employee, or highly compensated individual within the meaning of Code § 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)
- In addition to top employees, a 5% owner (who is not an employee) is also within Code § 101(j)(5)(A) and Code § 101(j)(2)(A)(ii)

Reg. § 1.101-1(d)(3) "Substantial Financial Relationship" (II.Q.4.b.ii.(b))

- 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
- *E.g.*, buy-sell agreement re: common investment

Reg. § 1.101-1(d)(3) "Substantial Financial Relationship" (II.Q.4.b.ii.(b))

- 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
- *E.g.*, funding loans or loan guarantees called when the insured dies
- *E.g.*, funding required purchase of the insured's business interest

Reg. § 1.101-1(d)(3) "Substantial Financial Relationship" (II.Q.4.b.ii.(b))

- 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
- I asked the government to recognize other ties to charity, but they declined, saying that objective proof must be required. However, they left an opening, in case someone could formulate a test and persuade the IRS to publish guidance other than regulations.

Reg. § 1.101-1(d)(4) Special Rules (II.Q.4.b.ii.(b))

- 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
- 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

Reg. § 1.101-1(d)(4) Special Rules (II.Q.4.b.ii.(b))

- 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
- 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 a charity with sufficient ties

Reg. § 1.101-1(f)(1) Beneficial Owner (II.Q.4.b.ii.(b))

- 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

Reg. § 1.101-1(f)(1) Beneficial Owner (II.Q.4.b.ii.(b))

- In applying this test, 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
- In tax regulations, "include" usually means "without limitation," so query the scope
- Proposed regulations had treated trust as having the requisite connection only when all of the beneficiaries were qualified family members
- Final regulations respond to my comment that should be OK for trust to include any beneficiary with a qualified connection

Reg. § 1.101-1(c)(2) - Deemed Not a Reportable Policy Sale (II.Q.4.b.ii.(b))

- Transfer of interest in policy 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% ownership interest from that beneficial owner's ownership interest in the transferee entity; for trusts, assume maximum exercise of discretion
- Affiliated group filing consolidated return that year
- Indirect acquisition if entity owning policy reports under Code § 6050Y and regs (or owned policy before 1/1/2019), no more than 50% of entity's gross assets are life insurance, and the indirect owner owns no more than 5% of direct owner

Reg. § 1.101-1(c)(2) - Deemed Not a Reportable Policy Sale (II.Q.4.b.ii.(b))

Final regulations added:

- The acquisition of a life insurance contract by an insurance company that issues a life insurance contract in an exchange pursuant to Code § 1035
- The acquisition of a life insurance contract by a policyholder in an exchange pursuant to Code § 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

Rules When Not a Reportable Policy Sale (II.Q.4.b.ii.(c))

When not a reportable policy sale and policy is not tainted by a prior reportable policy sale:

- If transfer is to permitted transferee, then transfer for value rule does not apply
- If substituted basis transfer not to a permitted transferee, then any exclusion of death benefit that would have applied to the transferor will apply to the transferee, plus transferee gets credit for own payments

Rule When Prior Reportable Policy Sale (II.Q.4.b.ii.(c))

Reg. § 1.101-1(b)(1)(ii)(B)(2) - when policy tainted by prior reportable policy sale, the excludable death benefit is limited to the sum of:

- The higher of the amount that would have been excludable by the transferor if the transfer had not occurred [which itself would be limited by the taint] or 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

Cleansing Policy (II.Q.4.b.ii.(c), (d))

No prior reportable policy sale:

- Prior regulations cleanse policy only if the final transfer is to a permitted transferee ***for a valuable consideration***
- In response to my comments, new Reg. § 1.101-1(b)(2)(i) provides cleansing (emphasis added): "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."
- That cleansing can apply to subsequent transferees, when appropriate

Cleansing Policy (II.Q.4.b.ii.(c), (d))

If prior reportable policy sale:

- In response to my comments, new Reg. § 1.101-1(b)(1)(ii)(B)(3)(i) provides cleansing when the insured buys for fair market value
- If bargain sale, divide into part bought for fair market value that is cleansed and gratuitous transfer, that carries the reportable policy sale taint
- Reg. § 1.101-1(b)(1)(ii)(B)(3)(ii) – limitations on cleansing when the insured transfers after buying for fair market value (next slides)

Cleansing Policy (II.Q.4.b.ii.(c), (d))

Reg. § 1.101-1(b)(1)(ii)(B)(3)(ii) –when the insured transfers after buying for fair market value:

- If all such transfers are gratuitous, the policy remains cleansed
- If and to the extent any later transfer is for valuable consideration or is a reportable policy sale, reapply Reg. § 1.101-1(b); if the amount that would have been excludable from gross income by the insured following the cleansing if no subsequent transfer had occurred is relevant, that amount is determined under Reg. § 1.101-1(b)(1)(ii)(B)(2); see Example 9 further below

Reg. § 1.101-1(e)(1) Interest in a Life Insurance Contract (II.Q.4.b.ii.(a))

Interest in a life insurance contract:

- Means the interest held by any person that has taken title to or possession of the life insurance policy, in whole or part, for state law purposes (including nominee)
- Also includes 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 Reg. § 20.2042-1(c)(2), 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. § 1.101-1(e)(2) – Transfer of an Interest in a Life Insurance Contract (II.Q.4.b.ii.(a))

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
- Includes the creation of an enforceable right to receive all or a part of the proceeds of a life insurance contract

Reg. § 1.101-1(e)(2) – Transfer of an Interest in a Life Insurance Contract (II.Q.4.b.ii.(a))

Transfer of an interest in a life insurance contract does not include:

- 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
- the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to Code § 1035

Reg. § 1.101-1(e)(3) – Acquisition of an Interest in a Life Insurance Contract (II.Q.4.b.ii.(a))

- Acquisition of an interest in a life insurance contract may be direct or indirect
- 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
- "Other entity" does not include a C corp, unless more than 50% of the gross value of the assets of the C corp consists of life insurance contracts immediately before the indirect acquisition

Indirect Transfers (II.Q.4.b.ii.(g))

- Definition of "reportable policy sale" is important for transfer for value (income tax) and reporting purposes
- Transfer for value rule applies to a transfer of "a life insurance contract or any interest therein"
- Rules on indirect transfers are used only to define "reportable policy sale"
- Pre-2018 law said that transfer of an interest in an entity did not constitute a transfer of the underlying policy

Indirect Transfers (II.Q.4.b.ii.(g))

- Reg. § 1.101-1(e)(1) - 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).
- "Better" view – an indirect transfer of a life insurance policy being classified as a reportable policy sale is relevant only for reporting purposes and not for income tax purposes
- However, may want to take advantage of income tax safe harbor for indirect transfers that are reported

Reg. § 1.101-1(g) – Examples (II.Q.4.b.ii.)

- Each example assumes that the transferee did not receive any amounts
- Exception for Example 7, the bargain sale rules do not apply because the consideration paid for the policy transferred is fair market value

Reg. § 1.101-1(g)(1) – Example 1 (II.Q.4.b.ii.(d))

- The insured is the initial policyholder
- The insured sells to the insured's child
- The insured and child are not partners
- Sale means transfer for valuable consideration
- Not a reportable policy because transferee is the transferor's child

Reg. § 1.101-1(g)(1) – Example 1 (II.Q.4.b.ii.(d))

- However, the sale is not a permitted transfer and the buyer is not a permitted transferee under the pre-2018 rule
- Thus, death benefit is tax-free only the extent of the child's purchase price plus premiums and other payments by the child

Reg. § 1.101-1(g)(2) – Example 2 (II.Q.4.b.ii.(d))

- Same facts as Example 1, except the child gives the policy to the insured before the insured dies
- Because never any reportable policy sale and the transfer to the insured was gratuitous, the gift to the insured cleanses the policy

Reg. § 1.101-1(g)(3) – Example 3 (II.Q.4.b.ii.(d))

- Same facts as Example 1, except the child sells the policy to the insured before the insured dies
- The sale is not a reportable policy sale because the acquirer is a family member of the insured (the insured herself)
- Cleansed by transfer to the insured

Reg. § 1.101-1(g)(4) – Example 4 (II.Q.4.b.ii.(d))

- 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
- Thus, transfer is a reportable policy sale
- Death benefit taxed except for sum of $6,000 and premiums and other amounts paid by C

Reg. § 1.101-1(g)(5) – Example 5 (II.Q.4.b.ii.(d))

- Same facts as Example 4
- 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
- Transfer from C to D is not a reportable policy sale, because D has a substantial financial relationship with A
- However, policy still tainted because transfer from A to C was a reportable policy sale

Reg. § 1.101-1(g)(5) – Example 5 (II.Q.4.b.ii.(d))

Death benefit is taxable, except for the sum of:

- 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 after the transfer to C) or the amount D paid ($8,000); and
- Any premiums and other amounts paid by D after the transfer to D

Reg. § 1.101-1(g)(6) – Example 6 (II.Q.4.b.ii.(d))

- Same facts as Example 4, except that C sells the policy to A for FMV
- Transfer from C to A is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A
- Sale to the insured, A, cleanses the reportable policy sale and cleanses the prior transfer for value
- Death benefit not taxable at all

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Reg. § 1.101-1(g)(7) – Example 7
Example 6 But With Bargain Sale (II.Q.4.b.ii.(d))

- Same as Example 6, except C sells policy to A for $4,000 instead of its $8,000 FMV
- Transfer from C to A is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A
- Because tainted by prior reportable policy sale, need to analyze sale under bargain sale rule
- Purchase for 50% of FMV means 50% of policy was sold to A for FMV and 50% was gratuitous transfer to A

Reg. § 1.101-1(g)(7) – Example 7
Example 6 But With Bargain Sale (II.Q.4.b.ii.(d))

For sale of $50,000 policy (50% of $100,000 policy):

- Sale to the insured, A, cleanses the reportable policy sale and cleanses the prior transfer for value
- Death benefit not taxable at all

Reg. § 1.101-1(g)(7) – Example 7
Example 6 But With Bargain Sale (II.Q.4.b.ii.(d))

For gratuitous transfer, all of the $50,000 death benefit is taxable except the sum of:

- The amount C could have excluded with respect to 50% of the policy had the transfer back to A not occurred (50% of the $6,000 that C paid A for the policy, plus 50% of any premiums and other amounts paid by C after the transfer to C), plus
- 50% of any premiums and other amounts paid by A after the transfer to A

Reg. § 1.101-1(g)(8) – Example 8 (II.Q.4.b.ii.(d))

- Same as Example 6, except 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
- Transfer to B was not a transfer for value (no valuable consideration)
- For reporting purposes, also not a reportable policy sale
- Death benefit received by B is not taxable

Reg. § 1.101-1(g)(8) – Example 8 (II.Q.4.b.ii.(d))

- Transfer to E was for consideration and was a reportable policy sale
- E's death benefit is taxable is to the extent of the sum of:
  - the consideration paid by E, plus
  - premiums and other amounts paid by E with respect to the policy after the transfer to E

Reg. § 1.101-1(g)(9) – Example 9 (II.Q.4.b.ii.(d))

- Same facts as Example 8, except that 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
- Because Partnership F consists of the insured and the insured's family members, the transfer to it was not a reportable policy sale
- Because transfer for value and substituted basis transfer, Partnership F looks to what B could have excluded

Reg. § 1.101-1(g)(9) – Example 9 (II.Q.4.b.ii.(d))

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 Reg. § 1.101-1(b)(2)(i) to the sum of:

- the amount A could have excluded had the transfer to B not occurred, plus
- any premiums and other amounts paid by B with respect to the policy after the transfer to B

Reg. § 1.101-1(g)(9) – Example 9 (II.Q.4.b.ii.(d))

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 after the transfer to A

Reg. § 1.101-1(g)(10) – Example 10 (II.Q.4.b.ii.(c))

- 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
- Under the regular transfer for value rule, the contribution is a permitted transfer and Corporation X is a permitted transferee

Reg. § 1.101-1(g)(10) – Example 10 (II.Q.4.b.ii.(c))

- 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
- Thus, Corporation X has a substantial business relationship with the insured, and the transfer is not a reportable policy sale
- The transfer for value rule does not tax the death benefit
- However, beware Code § 101(j) (II.Q.4.g.)

Reg. § 1.101-1(g)(11) – Example 11 (II.Q.4.b.ii.(c))

- Same facts as in Example 10, but Corporation X transfers its active trade or business and the policy on A's life to Corporation Y in a tax-free reorganization 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

Reg. § 1.101-1(g)(11) – Example 11 (II.Q.4.b.ii.(c))

- Transfer from Corporation X to Corporation Y is not a reportable policy sale because Corporation Y has a substantial business relationship with A
- Corporation Y may exclude 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 after the transfer
- Because Corporation X's exclusion is not limited, Corporation Y's exclusion is not limited

Reg. § 1.101-1(g)(12) – Example 12 (II.Q.4.b.ii.(c))

- 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
- 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 after the transfer

Reg. § 1.101-1(g)(13) – Example 13 (II.Q.4.b.ii.(b))

- 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.

Reg. § 1.101-1(g)(13) – Example 13 (II.Q.4.b.ii.(b))

- Partnership X is the initial policyholder of a $100,000 insurance policy on the life of A
- Partnership Y buys the policy from Partnership X
- 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)(14) – Example 14 (II.Q.4.b.ii.(b))

- Partnership X conducts an active trade or business and is the initial policyholder of a 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

Reg. § 1.101-1(g)(14) – Example 14 (II.Q.4.b.ii.(b))

- B does not have a substantial family, business, or financial relationship directly with A
- However, Partnership X (the direct policyholder) has a substantial business relationship with A, and that relationship passes through to B
- 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)(15) – Example 15 (II.Q.4.b.ii.(b))

- The facts are the same as in Example 14, 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

Reg. § 1.101-1(g)(15) – Example 15 (II.Q.4.b.ii.(b))

- 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
- However, 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, B's indirect acquisition of an interest in the policy covering A's life is not a reportable policy sale

Reg. § 1.101-1(g)(16) – Example 16 (II.Q.4.b.ii.(b))

- A sells a policy on A's for its fair market value, as a result which 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.
- Neither Bank X nor Partnership B has a substantial family, business, or financial relationship with the insured, A, at the time of the sale
- Thus, the transfer of legal title to the policy to Bank X and the transfer of the economic benefits of the policy to Partnership B are reportable policy sales, unless an exception applies

Reg. § 1.101-1(g)(16) – Example 16 (II.Q.4.b.ii.(b))

- Later, 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, at the time of the transfer
- Thus, Partnership C's acquisition of the economic interest in the policy from Partnership B is a reportable policy sale, unless an exception applies.

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Response to Comments on Bank-Owned Life Insurance (BOLI) (II.Q.4.b.ii.(b))

- 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
- 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

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Response to Comments on Bank-Owned Life Insurance (BOLI) (II.Q.4.b.ii.(b))

- 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
- BOLI pooling transactions at 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
- 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

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Response to Comments on Bank-Owned Life Insurance (BOLI) (II.Q.4.b.ii.(b))

- Preamble rejected the requested relied
- First, BOLI partnerships have no relationship with the insureds
- Second, the employers are shifting their risks to other employers, so the insurance is not targeted to their risks for their specific employees
- However, preamble suggested that BOLI participants might see whether meet the test for indirect acquisition if entity owning policy reports under Code § 6050Y and regs (or owned policy before 1/1/2019), no more than 50% of entity's gross assets are life insurance, and the indirect owner owns no more than 5% of direct owner

Employer Owned Life Insurance Requirement To Avoid Income Taxation

- Company owned policy issued or materially changed after August 17, 2006
- 5% or greater owner or a highly compensated employee

Employer Owned Life Insurance Requirements To Avoid Taxation

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- Notice and consent must be obtained on or before policy issuance
- Notice can be stand-alone or can be incorporated into buy-sell agreement, but need to make sure signed on or before policy issuance
- Notice can be drafted by attorneys or provided by agents – make sure a qualified tax advisor reviews whatever the agent provides
- Form 8925 – must be attached to corporate income tax return annually

Employer Owned Life Insurance Consent For Owner Who Is Not an Employee

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Notice and Consent

For _____
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.

Employer Owned Life Insurance Consent For An Employee

THOMPSON COBURN LLP

Notice and Consent

For _____

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.

Employer Owned Life Insurance
What To Do If You Don't Have Notice

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- Best option – get new policies, but this does not always work
- See if relief is available – do you have procedure in place and accidentally made a mistake, then you fix it in a short time?
- Buy-sell agreement can protect if the agreement includes notice and consent

Life Insurance LLC (II.Q.4.i.)

- Provides benefits of cross-purchase without most of the drawbacks
- More complicated than redemption

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

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- Trust Divisions (II.J.18.a.)
- Trust Mergers (II.J.18.b.)
- Decanting (II.J.18.c.)
- Trust Commutation (II.J.18.d.)
- Commutation vs Mere Division (II.J.18.f.)

Trust Divisions

(II.J.18.a)

- Partition of jointly owned property not a sale or other disposition of property when the co-owners of the joint property sever their joint interests
- If trustee not authorized to make non-pro rata distribution of property, deemed pro-rata distribution, then swap

Trust Divisions

(II.J.18.a)

- Reg. § 1.1001-1(h)
  - Authority to make non-pro rata distributions protects trust severances from income tax
  - Broad definition of "severance" could cover almost anything
- Letter Ruling 201928004 provides division not income taxable and not Code § 661 distribution

Trust Mergers

(II.J.18.b)

- Mergers combine beneficial interests and keep them intact
- Therefore, no exchange

Decanting

(II.J.18.c)

- Pouring from first trust to second trust
- If change only administrative provisions, new trust tends to be mere continuation of old trust
- Uniform Decanting Act allows amendment instead of distribution
- If change beneficial interests, possible big transfer tax (Code § 2702) and perhaps income tax

Commutation

(II.J.18.d)

- Trust termination that changes character of beneficial interests, even if beneficiaries receive full fair market value
- Generally life tenant can't use any basis, but remaindermen get proportionate basis

Commutation

(II.J.18.d)

- Surviving spouse buying out remaindermen of QTIP trust - Rev. Rul. 98-8 (applied Code § 2519 even though not transferring life interest) and Letter Ruling 200027001 (variety of issues)
- Reg. § 1.1014-5(c), "Sale or other disposition of a term interest in a tax-exempt trust"

Commutation

(II.J.18.d)

- If life tenant buys out remaindermen, remaindermen use basis
- Query what property life tenant uses to buy remaindermen
- If step transaction applies, beware that IRS treats commutation by trustee as most beneficiaries selling their interests

Commutation

(II.J.18.d)

- Letter Ruling 201932001 and its companion rulings treated court-approved agreement for trustee to distribute as most beneficiaries exchanging their interests with no transfer tax consequences but substantial income tax consequences
- Sale of beneficial interests = capital gain

Commutation

(II.J.18.d)

- Code § 1001(e)(3) – life tenant can use basis is sale is "part of a transaction in which the entire interest in property is transferred to any person or persons"
- Reg. § 1.1001-1(f)(3) narrows exception by requiring 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"

Commutation

(II.J.18.d)

- Code § 273 – cannot amortize "a life or terminable interest acquired by gift, bequest, or inheritance
- Rev. Rul. 62-132 – can amortize a purchased life estate
- Code § 167(e)(1) – cannot amortize "for any period during which the remainder interest in such property is held (directly or indirectly) by a related person"

Commutation

(II.J.18.d)

- Letter Ruling 8316135, quoting legislative history held: “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.’”
- Purchase was by contingent remainderman

Commutation

(II.J.18.d)

- Policy would suggest that any purchase that terminates the trust would preclude amortization of life estate and therefore should allow life tenant to use basis
- It would also suggest that Code § 167(e)(1) disallowance of amortization should allow life tenant to use basis
- But Reg. § 1.1001-1(f)(3) does not recognize these policy considerations

Commutation vs Mere Division

(II.J.18.f)

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Clash between

- Reg. § 1.1001-1(h), which could be broadly construed to protect most commutations so long as trustee distribution and non-pro rata distribution authorized, and
- Reg. § 1.1001-1(f)(3), assuming a commutation is taxable

Commutation vs Mere Division

(II.J.18.f)

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Reg. § 1.1002-1(b), "Strict construction of exceptions from general rule," provides:

> 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.

Commutation vs Mere Division

(II.J.18.f)

- Thus, Reg. § 1.1002-1(b) requires us to look deeply into the purpose of Reg. § 1.1001-1(h) to make sure it suffices to override the law of exchanges
- Is a beneficial interest an entitlement with a measurable expectation of financial benefits?

Commutation vs Mere Division

(II.J.18.f)

- Income interest or its equivalent (unitrust, annuity, etc.) can be measured
- Ascertainable standards tend to constitute a measurable economic interest
- For measuring other beneficial interests for gift tax purposes, see part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts

Commutation vs Mere Division

(II.J.18.f)

- 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, so if the entire beneficial interest is transferred and the distribution rules are different then they may need to be unitrust or annuity
- 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

Commutation vs Mere Division

(II.J.18.f)

- Guidance on trust divisions (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?

Commutation vs Mere Division

(II.J.18.f)

- Although not directly on point, Reg. § 1.1001-3, "Modifications of debt instruments," determines whether a modification of the terms of a debt instrument is an exchange under Reg. § 1.1001-1(a)
- 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, per Letter Ruling 201320004 (II.J.5.b.iii)

Commutation vs Mere Division

(II.J.18.f)

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- If a trust is purely discretionary (no 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

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- How the new safe harbor for real estate changed from its proposed terms and the extent to which the safe harbor helps
- Strategy for qualifying real estate rental as a trade or business under IRC § 199A independent of the safe harbor

Real Estate as QBI (II.E.1.e.)

Rental is deemed to be 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), whether or not it is aggregated. That control means that the same person or group of persons, directly or through Code § 267(b) or 707(b) attribution, owns 50% percent or more of each trade or business to be aggregated, 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.
- Rental to a C corporation does not qualify, because a C corporation cannot be aggregated

But, treated as SSTB if and to the extent leased to commonly controlled SSTB (II.E.1.c.iv.(o))

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

Preamble to final regs, T.D. 9847 (2/8/2019):

> 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).

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

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, then says, "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)."

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Safe harbor available with respect to a "rental real estate enterprise" (defined below)
- If safe harbor requirements are met, the rental real estate enterprise will be treated as a single trade or business when applying the regulations, including aggregation rules

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Safe harbor available with respect to a “rental real estate enterprise” (defined below)
- If safe harbor requirements are met, the rental real estate enterprise will be treated as a single trade or business when applying the regulations, including aggregation rules
- RPEs, as defined in § 1.199A-1(b)(10), may also use this safe harbor

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Rental real estate enterprise is 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
- Taxpayer or RPE must hold each interest directly or through an entity disregarded as an entity separate from its owner

Rental Real Estate & Code § 199A (II.E.1.e.i.(a).)

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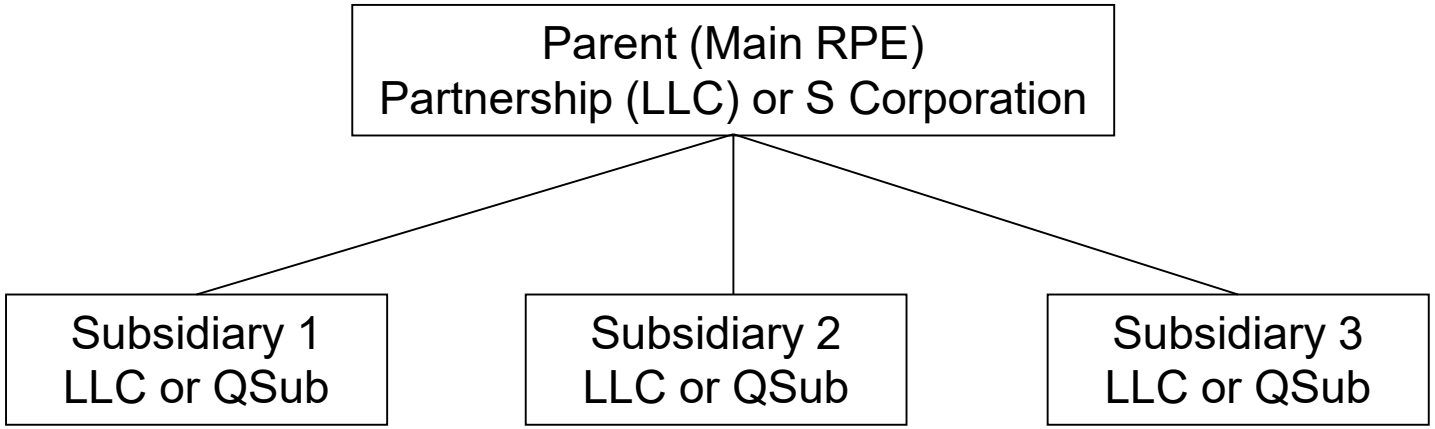
May need to restructure to have single member LLCs under the main RPE (if main RPE is an S corporation, also might use QSub) so that all real estate interests are one RPE and qualify as a single rental real estate enterprise:



Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Generally, taxpayers and RPEs may either treat each interest in similar rental property as a separate rental real estate enterprise or treat interests in all similar rental properties as a single rental real estate enterprise
- Thus, commercial rental may only be part of the same enterprise with other commercial rental(s), and residential rental may only be part of the same enterprise with other residential rental(s)

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Generally, taxpayers and RPEs may either treat each interest in similar rental property as a separate rental real estate enterprise or treat interests in all similar rental properties as a single rental real estate enterprise
- Thus, commercial rental may only be part of the same enterprise with other commercial rental(s), and residential rental may only be part of the same enterprise with other residential rental(s)

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Once taxpayer or RPE treats interests in similar properties as a single rental real estate enterprise under safe harbor, must continue to treat interests in all similar properties, including newly acquired properties, as a single rental real estate enterprise when rely on the safe harbor
- However, if treat each residential or commercial property interest separately, may later elect to combine all of them within applicable category

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

New rules/clarification in safe harbor:

- A single building with residential and commercial (mixed-use) may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests
- Each rental real estate enterprise that satisfies the requirements of the safe harbor is treated as a separate trade or business for purposes of applying Code § 199A and regs

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Annually decide whether to use the safe harbor
- Each rental real estate enterprise will be treated as a single trade or business if meet all of: (A) separate books and records for each rental real estate enterprise, (B) 250 or more hours of rental services each year (or three out of past five if exist four years), and (C) contemporaneous records – stricter than the passive loss rules. Changes in (A) & (C) from before – see materials

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Attach statement to timely filed original return
- Dropped requirement that statement signed under penalties of perjury
- List of what qualifies and what does not qualify as rental services essentially the same as before
- So is list of rental real estate arrangements excluded from safe harbor, other than expanding the reach of the triple net lease and anti-SSTB exclusions (both in following slides)

Rental Real Estate & Code § 199A

(II.E.1.e.i.(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***" (emphasis added)
- Used to be "… 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."

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- "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 disfavored triple net lease

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- 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 (see slides after safe harbor)
- 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 financial risk

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- Safe harbor also excludes 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)
- In contrast to this complete knockout when an SSTB is involved, SSTB rules knock out only that portion of the rental leased to the SSTB
- Rely on general rules instead of safe harbor

Trade or Business

- Best discussion - part II.I.8.c.iii Rental as a Trade or Business
- Part II.G.4.I.i.(a) “Trade or Business” Under Code § 162
- Part II.G.27.b Real Estate as a Trade or Business
- One rental to one tenant can qualify if the landlord does enough activity
- Safe harbor is much more stringent than case law
- However, consider keeping records that safe harbor would require

Real Estate as QBI (II.E.1.e.)

Should expenditures and employees move to landlord, with tenant reimbursing landlord for costs?

- Tenant may have plenty of wages and not need them for W-2 wage limitation; employees would help landlord with W-2 wage limitation calculation
- Are landlord's owners different from tenant's owners?
- Does landlord want to devote time to this active role?
- Landlord entity becomes liable for employees' action or inaction; whoever controls landlord may be personally liable for negligent hiring
- Consider perceived adequacy of liability insurance

Conclusion

- Gorin's Business Succession Solutions (quarterly newsletter)
- February 12, 2019 webinar Fiduciary Income Tax Refresher and Update 2019
- Blog: Business Succession Solutions
- Reports on Heckerling: http://www.thompsoncoburn.com/forms/gorin-heckerling