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PLANNING WITH LIFE INSURANCE LLCS AFTER *CONNELLY* AND *HUFFMAN*

By

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SESSION BB

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Steve Gorin is a nationally recognized practitioner in the areas of estate planning and the structuring of privately held businesses. Lawyers, accountants, and business owners regularly look to Steve for fresh, highly knowledgeable insights into the best possible tax and estate planning approaches to their transactions.

Steve skillfully crafts estate plans for individuals, keeping in mind their financial security and desire to save income and estate tax. In his work for businesses, Steve helps owners plan for the eventual sale (to co-owners, employees, or third parties) or transfer (to family members), and provides a legal framework for an orderly transition while strategically saving income, transfer, and FICA taxes.

Drawing on his background as an accountant — and his still-current CPA license and Chartered Global Management Accountant credential — Steve structures businesses to achieve business objectives and save income or estate tax. He has helped fledgling businesses organize, thriving businesses restructure to save hundreds of thousands of dollars of income tax when planning a transition to the next ownership group, and mature multi-million or billion-dollar businesses plan tax-saving transfers to the next generation.

Steve has amassed a deep knowledge of nearly every aspect of tax strategy for privately held businesses and freely shares that knowledge with others in the field. His quarterly newsletter, "Business Succession Solutions," is considered essential reading for thousands of CPAs and attorneys, who describe it as "a fantastic contribution to the field." It includes a link to several thousand pages of materials, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," and a free subscription is available at http:\www.thompsoncoburn.com\forms\gorinnewsletter. Lawyers and CPAs across the country ask Steve to help them with projects they might not otherwise feel comfortable doing alone, and Steve respects that they are the expert on their clients and that they should do as much of the ongoing work as possible.

Steve is a highly visible member of the ABA's Real Property, Trust & Estate Law Section and the American College of Trust & Estate Counsel, which regularly directs its members to Steve's quarterly newsletter. He has represented both groups in comments to the IRS, the U.S. Treasury, and tax lawmakers.

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Excerpts from:

Structuring Ownership of Privately-Owned Businesses:
Tax and Estate Planning Implications

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Excerpts from:

Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications

I. Introduction

This document 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.

With rapid changes in our global economy, flexibility in structuring a business entity is more important than ever. This document focuses on income tax flexibility in buying into a business

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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. This document may be cited as Gorin, [number and name of part as shown in the Table of Contents], "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (printed 5/20/2025), available by emailing the author at sgorin@thompsoncoburn.com. The author refers to this document not as a "treatise" or "book" but rather as his "materials," because the author views this as a mere compilation of preliminary ideas (albeit a large compilation) and not as a scholarly work.
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.

and also exiting from or dividing a business, also discussing particular aspects of the taxation of operations, as well as individual and fiduciary income taxation (including the 3.8% tax on net investment income) on the income relating to a business entity that is taxable to them. It also discusses estate planning issues, including transfer tax issues and drafting and administering trusts to hold business interests. In addition to the issues covered in this document, consider whether a family-controlled entity requires a legitimate and significant nontax reason.[1]

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

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

For free oral presentations of various issues in this document, go to my CPA Academy instructor page. These webinars are free and available on demand without continuing education credit or at scheduled times with CPE credit. The last Tuesday of the month after a calendar quarter ends, I record a free TCLE webinar with CLE credit in California, Illinois, Missouri and New York covering the articles in the quarterly newsletter. My blog cited in the preceding paragraph has a link to Business Succession TCLE Recordings; click "VIEW ALL" at the bottom to get a list of the current and all prior available free TCLE recordings. Additional Thompson Coburn LLP resources are at https://www.thompsoncoburn.com/subscribe.

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

This part II.Q.4.g begins with practical issues of part II.Q.4.a Funding the Buy-Sell.

Because life insurance is so commonly used to fund buy-sell agreements, it then delves into various life insurance issues in parts:

- II.Q.4.b Transfer for Value Rule; Basis
- II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035
- II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy)
- II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies

[1] Such a reason may be necessary to ensure estate tax recognition of the entity and to avoid double inclusion of the post-formation appreciation in the value of any business interest the decedent owned within three years of death. See fns. 91-92 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.

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

- II.Q.4.g Income Tax Trap for Business-Owned Life Insurance

The next issue is part II.Q.4.h Establishing Estate Tax Values, which includes not only gift/estate tax issues in transferring a business interest but also estate tax issues caused by life insurance held by a business to redeem the insured's business interest.

To avoid the latter, the owners might agree to buy each other's interest on death (a "cross purchase"). A solution to several issues raised by a cross purchase is in part II.Q.4.i Life Insurance LLC.

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

Insurance is by far the most common method by which a buy-sell agreement is funded, whichever form of agreement is used. Special rules apply if the beneficiary is two generations (or the equivalent) younger than the insured.[4346] If a business owner has a parent with an

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[4346] If the policy proceeds are $250,000 or more, the life insurance company will need to verify with the beneficiary that the beneficiary is not a skip person receiving a payment subject to generation-skipping transfer (GST) tax; otherwise the insurance company might need to file relevant forms reporting and paying GST tax. Reg. § 26.2662-1(c)(2)(vi) explains:

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

estate tax problem, that parent's estate tax problem might lend itself to a special opportunity to pay for the policies that fund the buy-sell.[4347]

Not enough attention is focused on disability insurance, which can protect the business' cash flow due to the interruption caused and might also help fund buyouts. To the extent disability is to benefit the disabled person, one should avoid the draconian Code § 409A rules,[4348] which have a stringent disability provision,[4349] and instead pay the key employee compensation sufficient for that person to buy his or her own disability policy.

Having life insurance proceeds paid directly to the selling shareholder does not make the sale tax-free; rather, the payment is treated just as would be any other payment to a seller[4350] (which might be tax-free if the seller has sufficient basis, for example because of a basis step-up in the business interest).

Funding with life insurance under a cross-purchase plan will require that each shareholder own a life insurance policy on the life of every other shareholder. If there are more than three owners, however, policy ownership can become complicated and a stock redemption agreement may make better sense. One alternative to a stock redemption agreement may be a trusteed agreement whereby the trustee would act as custodian of the policies and purchase one life insurance policy for each shareholder. This avoids the need for multiple policies when there are more than two shareholders. If a stock redemption arrangement is employed, the corporation purchases a life insurance policy on each shareholder. Upon the shareholder's death, the beneficiary then uses the proceeds to purchase the decedent's shares. Similarly, as described in a Letter Ruling, the shareholders could form a limited liability company to own life insurance on each other, with the manager of the LLC retaining the proceeds until the parties agree on proper application of the proceeds.[4351] Also note that split-dollar life insurance arrangements[4352] are subject to Code § 409A rules restricting the events upon which deferred compensation can be paid, the violation of which trigger significant tax, penalties, and

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

[4347] This tool, generational split-dollar, is described as it was approved in fns. 4584-4586 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4348] See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

[4349] See part III.B.7.c.vi Deferred Compensation, especially fn. 7466.

[4350] For an analogous situation, see Rev. Rul. 70-254, which is based on *Landfield Finance Company v. U.S.*, 418 F. 2d 172 (7th Cir. 1969), which in turn is based on Reg. § 1.101-1(b)(4).

[4351] See part II.Q.4.i Life Insurance LLC.

[4352] Split-dollar is a cash value life insurance financing arrangement described in Reg. §§ 1.61-22 and 1.7872-15, with cross-references found in Reg. §§ 1.83-6(a)(5) (income tax treatment on rollout of employee split-dollar), 1.301-1(q) (shareholder arrangements), and 1.1402(a)-18 (self-employment tax issues). See part II.Q.4.f Split-Dollar Arrangements, especially part II.Q.4.i.ii.(b) Corporate Ownership of Policy, including *Machacek v. Commissioner*, where the Sixth Circuit, reversing the Tax Court and ignoring the parties' briefs, held that Reg. § 1.301-1(q) caused economic benefits under even compensatory split-dollar agreements to be treated as distributions and not compensation income to an employee-shareholder.

interest.[4353] When drafting a shareholder agreement using life insurance, consider authorizing transfers of the policy to the insured for fair market value to avoid Code § 409A risks; defining the value as cash surrender value might not be sufficient, particularly because features, such as no-lapse guarantees (which is the equivalent of prepaid insurance that is not revealed on annual insurance policy statements), provide additional value that is tracked through the life insurance company's internal "shadow account" that can provide surprising results when the insurance company issues IRS Form 712.[4354] Also, make sure that any rights an insured might have to purchase a policy others hold on his life arise only as a collateral consequence of acts or events of independent significance,[4355] so that they do not constitute an incident of ownership.[4356]

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

When using life insurance, make sure the beneficiary is the owner. Otherwise, when the insured dies, the owner is deemed to have transferred the death benefit to the beneficiary.[4357]

In a redemption agreement, the value of the insurance on the decedent's life will not be includable in the decedent's gross estate for federal estate tax purposes if the corporation is the

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[4353] Notice 2007-34 sets forth transition rules. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules, for a discussion of Code § 409A, including the permissible triggering events. Events that terminate pre-2005 split-dollar agreements often do not comply with these permissible triggering events, so a review of pre-2005 split-dollar agreements is a good idea. See Zaritsky, Aghdami & Mancini, ¶8.02. Life Insurance Funding, *Structuring Buy-Sell Agreements: Analysis With Forms*.

[4354] In the case of a split-dollar arrangement entered into on or before September 17, 2003, and which is not materially modified after that date, only the cash surrender value of the contract is considered to be property. Reg. § 1.83-3(e). Reg. §§ 20.2031-8 and 25.2512-6 determine the value for estate and gift tax purposes - based primarily on interpolated terminal reserve as a measure of the replacement value.

[4355] See part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance.

[4356] Letter Ruling 8049002 held that no incidents of ownership existed when a shareholder agreement gave the decedent the option to purchase policies at a price equal to the transfer value (cash surrender value), which option was exercisable only if decedent terminated his shareholder relationship with the corporation by offering all stock to the corporation and/or the other principal. This first-refusal option would become operative when a shareholder receives a bona fide offer, a shareholder terminates employment, or a shareholder becomes totally and permanently incapacitated. At date of death, although the option was still outstanding, the decedent had not terminated his shareholder relationship or acted in any way to exercise his option with respect to the insurance policies. The ruling was based on Rev. Ruls. 72-307, 75-50, and 79-46, from which the IRS gleaned an absence of incidents of ownership because the decedent could not independently initiate the events which would enable him to gain control over the policies (except, perhaps, by terminating employment, and, even then, he would not control the corporation's decision to repurchase). Thus, he lacked not only the practical ability to exercise any power with respect to these policies but also any power over the policies. Letter Ruling 9233006 also found no incidents of ownership when shareholders could buy policies on their respective lives and, thus, prevent cancellation of these policies only if the corporation redeems their stock interests in the event that the insured is disabled for a prescribed period of time, the insured declines to participate in the sale of the corporation to a third party, or the insured declines to participate in a public offering of the corporation's stock. Thus, the right to acquire the insurance policies and thus, prevent cancellation would arise as a collateral consequence of acts or events of independent significance. That ruling also cited Rev. Ruls. 84-130 and 80-255. The ability to cancel a death benefit by divorcing one's spouse does not generate Code § 2038(a)(1) inclusion; see part III.D Code § 2038.

[4357] *Goodman v. Commissioner of Internal Revenue*, 156 F.2d 218 (2nd Cir. 1946).

owner and beneficiary of the policy,[4358] and the insurance proceeds received by the corporation will not be subject to income tax.[4359] Unless a valid agreement that satisfies Code § 2703[4360] provides otherwise, the insurance proceeds will, however, be considered in valuing the decedent's interest in the business,[4361] but perhaps offset by the buy-sell obligation.[4362]

Insurance premiums used to fund the agreement are not deductible by the corporation.[4363] Same with "any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual, or any endowment or annuity contracts owned by the taxpayer covering any individual."[4364] This rule disallowing interest does "not apply to any interest paid or accrued on any indebtedness with respect to policies or contracts covering an individual who is a key person to the extent that the aggregate amount of such indebtedness with respect to policies and contracts covering such individual does not exceed $50,000."[4365] In this context, "key person" means an officer or 20% owner, except that the number of individuals who may be treated as key persons with respect to any taxpayer cannot exceed the greater of (A) five individuals, or (B) the lesser of 5% of the total officers and employees of the taxpayer or 20 individuals.[4366] In this context, a "20% owner" means any person who owns directly 20% or more of the outstanding stock of a corporation, stock possessing 20% or more of the total combined voting power of all stock of a corporation, or 20% or more of the capital or profits interest in a partnership.[4367] For purposes of determining stock ownership and applying the $50,000 debt limit, all members of a controlled group are

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[4358] Rev. Rul. 82-85, relying on Reg. § 20.2042-1(c)(6), which is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy. If the decedent controls the entity that owns the policy and the insurance proceeds are not payable to the corporation or otherwise used for a valid business purpose (such as in satisfaction of a business debt of the corporation) so that the net worth of the corporation is increased by the amount of such proceeds, then the proceeds are includible in the decedent's estate. Reg. § 20.2042-1(c)(6). For purposes of determining whether a decedent controlled stock, the decedent will not be attributed ownership of a trust that the decedent did not create with respect to which the decedent was not the deemed owner under the grantor trust income tax rules. Letter Rulings 9808024 (decedent not deemed owner of trust and therefore not attributed stock ownership), 9511046 (decedent attributed stock ownership as deemed owner of QSST). Also, Code § 2035 causes inclusion if the life insurance proceeds are payable to a third party for other than a Reg. § 20.2042-1(c)(6) business purpose and: (a) the corporation, for less than adequate and full consideration, assigns an insurance policy on the stockholder's life and the stockholder then disposes of control of the corporation, or (b) within three years of death the stockholder had a controlling interest in a corporation that owns a life insurance policy on the stockholder's life. Rev. Rul. 90-21. Situation (2) of Rev. Rul. 90-21 reasoned that a shareholder who holds a non-controlling interest would not hold incidents of ownership; however, the facts did not indicate whether the shareholder had any authority to exercise any control over the policy.
[4359] Code § 101(a)(1). However, the death benefit might trigger significant alternative minimum tax (AMT), because book-tax differences generate an AMT preference. See part II.Q.7.a.v Redemptions and Alternative Minimum Tax.
[4360] See part II.Q.4.h Establishing Estate Tax Values.
[4361] Reg. § 20.2031-2(f); *Newell v. Commissioner*, 66 F.2d 102 (7th Cir. 1933).
[4362] In *Blount*, the Tax Court included the life insurance in the business' value, but the 11th Circuit reversed, holding that the buy-sell obligation offset the inclusion in the company's value.
[4363] Code § 264(a)(1).
[4364] Code § 264(a)(4). However, such interest reduces earnings and profits if the payor is a C corporation. Rev. Rul. 2009-25.
[4365] Code § 264(e)(1). However, Code § 264(e)(2) may limit the interest deduction to a particular rate.
[4366] Code § 264(e)(3).
[4367] Code § 264(e)(4).

treated as one taxpayer, and this limitation shall be allocated among the members of such group in such manner as the Treasury/IRS may prescribe.[4368]

A cross-purchase generally would constitute a taxable sale, treated as a capital gain.[4369] In many cases, a cross-purchase or a redemption that is paid over time can qualify for tax deferral as an installment sale.[4370] However, tax deferral on installment sales can be limited,[4371] so do not assume that it is available without our first having the rules thoroughly researched.

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

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

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

[4368] Code § 264(e)(5)(A). Code § 264(e)(5)(B), "Controlled group," provides:

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

[4369] However, in a partnership, part of the sale might constitute ordinary income under Code § 751. See part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.

[4370] Code § 453.

[4371] Code § 453A.

retirement plan concept of entire cash value against the nonexempt employee trust concept of entire value:

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

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

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

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

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

For estate and gift tax purposes, the IRS Form 712 value is usually, but not always, appropriate. Reg. § 25.2512-6(a) provides:

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

Dematteo v. Commissioner, Tax Court Docket 3634-21 (7/21/2022), declined the request for "a determination that a particular method of valuation of certain life insurance policies may be used by petitioner for gift tax purposes." The court refused to choose between Form 712 and another method, saying that the answer:

> [Depends] on the evidence of the nature of the policies and the quality of the respective valuations. Both must be approximations that are reasonable and reliable….

Reg. § 20.2031-8(a)(1), (2) provide:

> (1) The value of a contract for the payment of an annuity, or an insurance policy on the life of a person other than the decedent, issued by a company regularly engaged in the selling of contracts of that character is established through the sale by that company of comparable contracts. An annuity payable under a combination annuity contract and life insurance policy on the decedent's life (e.g., a retirement income policy with death benefit) under which there was no insurance element at the time of the decedent's death (see paragraph (d) of § 20.2039-1) is treated like a contract for the payment of an annuity for purposes of this section.
>
> (2) As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when, at the date of the decedent's death, the contract has been in force for some time and further premium payments are to be made, the value may be approximate by adding to the interpolated terminal reserve at the date of the decedent's death the proportionate part of the gross premium last paid before the date of the decedent's death which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such an approximation is not reasonably close to the full value of the contract, this method may not be used.

Rev. Rul. 78-137 held:

> In general, the replacement cost of a single premium policy will determine the value of the policy for gift tax purposes. *United States v. Ryerson*, 312 U.S. 260 (1941), Ct. D. 1488, 1941-1 C.B. 447. The replacement cost is based upon the single premium cost of a comparable policy. *Candler v. Allen*, 43 F.Supp. 435 (M.D. Ga. 1942). Generally, the estate tax and gift tax provisions are in *pari materia*. *Sanford Estate v. Commissioner*, 308 U.S. 39 (1939), Ct. D. 426, 1939-2 C.B. 340.
>
> In order for an insurance policy to qualify as a comparable contract within the meaning of section 20.2031-8(a), the policy must provide the same economic benefits as the policy owned by the decedent. *Candler v. Allen*, above at 437. The economic benefits of a single premium life insurance policy consist of an entire bundle of rights including the right to surrender the policy, the right to retain it for investment virtues, the right to borrow the cash surrender value of the policy and the right to payment of the face amount on the death of the insured. *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), Ct. D. 1487, 1941-1 C.B. 445; *Candler v. Allen*, above at 437. All of the economic benefits of the decedent's policy must be taken into consideration. To single out one economic benefit of the decedent's policy and to disregard the others is, in effect, to substitute a different property interest for the one that was owned by the decedent. *Cf. Guggenheim v. Rasquin*, above at 257.

> Since the cash surrender value of the replacement policy is less than the cash surrender value of the decedent's policy, the replacement policy does not reflect all of the economic benefits of the policy owned by the decedent. Therefore, the replacement policy is not a comparable contract within the meaning of section 20.2031-8(a) of the regulations. Accordingly, in the present case, the value of the policy owned by A on the life of A's child shall be determined, for Federal estate tax purposes, by reference to a comparable contract that reflects all of the economic benefits of the decedent's policy. If, however, information pertaining to a comparable contract is not obtainable, the value of the policy shall be determined by reference to the interpolated terminal reserve value of the policy pursuant to section 20.2031-8(a)(2) of the regulations, quoted above.

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

In a cross purchase funded by life insurance, consider not only the transfer for value but also income tax rules when an owner enters or exits the ownership group. How will policies on the existing owners be transferred to the new owner? How will policies that a departing owner owns be transferred when that person leaves, and how will policies on that person's life be transferred from the other owners? Consider not only income tax but also Code § 409A nonqualified deferred compensation issues. One might use a Life Insurance LLC to minimize these potentially adverse tax consequences – particularly when new insurance can be obtained.[4372]

Using split-dollar arrangements[4373] to fund a cross-purchase might also help when unwinding the arrangement. The insured pays the premiums and is deemed the policy owner under the split-dollar regulations,[4374] but the other business owners are entitled to the term insurance component of the death benefit and hold title and all other incidents of ownership with respect to the policy.[4375] If the insured leaves the business, the policy is transferred to the insured (or, preferably, an irrevocable grantor trust established by the insured); the transfer of the policy to the insured is not deemed a transfer for income tax purposes because the insured was already deemed to be the owner.

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

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

If life insurance policies can be transferred among the shareholders or from the corporation to the shareholders, the transfer for value rules must be examined. The transfer-for-value rule states that, if consideration is given for the transfer of an insurance policy, then the proceeds of

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[4372] See part II.Q.4.i, Life Insurance LLC.
[4373] See part II.Q.4.f Split-Dollar Arrangements.
[4374] Reg. § 1.61-22(c).
[4375] To avoid estate tax inclusion under Code § 2042.

the policy will be taxed as income to the owner-beneficiary upon the insured's death.[4376] Specifically:[4377]

> 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,[4378] 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;[4379] 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.[4380]

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)[4381] – as a transfer for valuable consideration. Also, Reg. § 1.101-1(g)(10), Example 10 assumes that a transfer to a corporation is a transfer for value.

[4376] 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.

[4377] Reg. § 1.101-1(f)(5).

[4378] 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.

Rev. Rul. 74-76 held no transfer for value when an employee-participant assigned a life insurance directly to a profit-sharing trust as a voluntary employee contribution.

[4379] 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).

[4380] *James F. Waters, Inc. v. Commissioner*, 160 F.2d 596 (9th Cir. 1947) (prior version of this statute).

[4381] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

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,[4382] 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.[4383] This exception looks at the deemed owner of a grantor trust.[4384] Rev. Rul. 2007-13 posited the following situations:

[4382] 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.

[4383] Code § 101(a)(2)(A), (B).

[4384] Note that Rev. Proc. 2019-3, Section 3.01(14) states that the IRS will not issue letter rulings on:

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

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

> Individual A and his spouse, Individual B, are the grantors of the AC Trust. The AC Trust, as amended, is represented to be a grantor trust for federal income tax purposes owned by Individual A and Individual B. The AC Trust, as amended, owns and is currently the beneficiary of Number Y life insurance contracts on the joint lives of Individual A and Individual B and the

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.

Rev. Rul. 2007-13 reasoned:

In Rev. Rul. 85-13, 1985-1 C.B. 184, a grantor acquired the corpus of a trust in exchange for the grantor's unsecured promissory note. The ruling concludes that the grantor is considered to have borrowed the corpus of the trust and, as a result, is treated as the owner of the trust under § 675(3). Because the grantor is treated as the owner of the trust, the grantor is deemed the owner of the trust assets for federal income tax purposes. In addition, because the grantor is therefore considered to own the purported consideration both before and after the transaction, the exchange of a promissory note for the trust assets is not recognized as a sale for federal income tax purposes.

In Situation 1, because G is treated as the owner of both TR1 and TR2 for federal income tax purposes, G is treated as the owner of all the assets of both trusts, including both the life insurance contract and the cash received for it, both before and after the exchange. Accordingly, in Situation 1 there has been no transfer of the contract within the meaning of § 101(a)(2).

In Situation 2, because G is treated as the owner of all the assets of TR1 but not of TR2 for federal income tax purposes, G is treated as the owner of the cash (but not the life insurance contract) before the exchange, and as the owner of the life insurance contract (but not the cash) after the exchange. Accordingly, in Situation 2 there has been a transfer of the life insurance contract for a valuable consideration within the meaning of § 101(a)(2). Nevertheless, the transfer for value limitations of § 101(a)(2) do not apply, because the transfer to TR1 is treated as a transfer to G, the insured, within the meaning of § 101(a)(2)(B).

Rev. Rul. 2007-13 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

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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.

> 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).

A gift subject to a policy loan that is not in excess of basis is a substituted basis transaction that does not trigger the transfer-for-value rule.[4385] 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.[4386] Similarly, contributing a life insurance policy to a partnership in a Code § 721 nontaxable transfer[4387] is a substituted basis transaction that is not subject to the original transfer for value rules[4388] but may need to be checked under the reportable policy sale rule under part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

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

Special rules apply to a "reportable policy sale," which is "the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance

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[4385] 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.

[4386] Letter Ruling 200826009. Note, however, that Rev. Proc. 2011-3, Section 3.01(8) states that the IRS will not issue letter rulings on:

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

[4387] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4388] Letter Ruling 201308019.

contract."[4389] "Indirectly" includes "the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract."[4390] 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.[4391] Thus, the death benefit generally is taxable, to the extent described in fn. 4376.

- Various reporting requirements apply when the death benefit is paid.[4392]

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 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

[4389] Code § 101(a)(3)(B).
[4390] Code § 101(a)(3)(B).
[4391] Code § 101(a)(3)(A).
[4392] Code § 6050Y, which is reproduced in part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.

> the seller (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (*i.e.*, the investment in the contract within the meaning of section 72(e)(6)), and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.
>
> *Reporting with respect to reportable death benefits*
>
> When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment, and (5) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.
>
> For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale…
>
> **Scope of transfer for value rules**
>
> The provision provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

The last paragraph above, consistent with the statutory language, does not say that a reportable policy sale is an additional type of transfer that is subject to the transfer for value rule; rather, it says that the exceptions to the transfer for value rule do not apply when the transfer is also a reportable policy sale. Notwithstanding this lack of income tax effect of a reportable policy sale that is not a transfer for value, a reportable policy may be subject to additional reporting obligations, which are purely informational.[4393]

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

[4393] For more about these nuances, see part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance, especially fn. 4441.

> 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 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).[4394]

[4394] [my footnote:] For Code § 101(j), see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

(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 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.
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> 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.
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> **A. Transfers to certain persons**
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> 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.[4395]

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 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

[4395] [My footnote:] I was that commenter.

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.
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> (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.
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> (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. 4377, 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)[4396] – 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.[4397]

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

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[4396] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4397] Especially text accompanying fn. 4436, as well as Example (2) that is discussed in the text accompanying fn. 4430.

> 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:[4398]

> 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 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

[4398] 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."

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[4399]

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

[4399] [My footnote – not in the preamble:] For why this exception may be perceived to be too narrow, see text accompanying fn. 4410 in part II.Q.4.b.ii.(c) "Reportable Policy Sale".

regulations should include additional provisions regarding the treatment of section 1035 exchanges of life insurance contracts. *See* 84 FR 11009, 11019.

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

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

In support of this position, the commenter explained that, mechanically, a section 1035 exchange typically involves the assignment by the policyholder of the existing policy to the carrier, followed by the surrender of the policy and the application of the cash proceeds as a premium under a new policy issued to the same owner on the same insured's life. The commenter remarked that, although the new carrier acquires an interest in the old policy, that interest is immediately extinguished. The commenter also remarked that treating the exchange as a reportable policy sale is not necessary to serve any information collection purpose in the case of an exchange involving a new, different carrier, because the exchange must be reported to the IRS and the policyholder on a Form 1099-R. Additionally, the commenter suggested that, even if an exchange were viewed as potentially meeting the definition of a reportable policy sale, the new carrier should be 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-108054-21, Information Reporting and Transfer for Valuable Consideration Rules for Section 1035 Exchanges of Life Insurance and Certain Other Life Insurance Contract Transactions (5/09/2023) describes how the regulations it proposes softens the approach to Code § 1035 exchanges:

Explanation of Provisions

Section 1035 Exchanges

As stated in the preamble to the final regulations, the concern prompting the references to section 1035 exchanges in the 2019 proposed regulations and the final regulations 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 the death benefits paid under the new policy might not be reported under section 6050Y(c). See 84 FR 58460, 58465. The section 1035 exchange provisions were not intended to change the treatment under section 101 of the policyholder's new contract if the policyholder's old contract was never transferred in a reportable policy sale.

However, the Treasury Department and the IRS have determined that such a change was inadvertently effected by the final regulations. Prior to the issuance of the final regulations, the transfer for value rule of section 101(a)(2) did not apply as the result of a section 1035 exchange of a life insurance contract by the original policyholder of the contract. However, under § 1.101-1(e)(2) of the final regulations, the issuance of a new policy in a section 1035 exchange is a transfer of an interest in a life insurance contract. Because the new policy is issued in exchange for an old policy, the exchange is a transfer for valuable consideration under § 1.101-1(f)(5) of the final regulations. Therefore, the new policy is subject to the transfer for value rule of section 101(a)(2), unless one of the exceptions in section 101(a)(2)(A) and (B) applies. For either exception to apply, there must be a substantial business, family, or financial relationship between the insured and the acquirer of the new policy. The Treasury Department and the IRS have determined that the carryover basis exception of section 101(a)(2)(A) would not apply in this case.[5] Therefore, the application of the transfer for value rule would generally limit the amount of death benefits excludable under section 101(a)(1), even in the absence of a reportable policy sale, unless one of the section 101(a)(2)(B) exceptions applies (that is, 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). The Treasury Department and the IRS have determined that this result is inconsistent with the prior treatment of new policies issued in section 1035 exchanges.

[5] The Code recognizes two categories of substituted basis property: transferred basis property and exchanged basis property. See section 7701(a)(42). Property has a “transferred basis” for Federal tax purposes when the same property is transferred from one person to another but keeps the same basis. See section 7701(a)(43). Property has an “exchanged basis” for Federal tax purposes when a person’s basis in new property is determined by reference to other property held by that same person. See section 7701(a)(44). The section 101(a)(2) “carryover basis” exception applies to a transfer if the transferred life insurance 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. That is, the exception applies if the contract is transferred basis property. However, the basis of a new policy issued in a section 1035 exchange to the same taxpayer is the same as the basis of the old policy held by that taxpayer, 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. See sections 1035(d)(2) and 1031(d). The new policy is thus exchanged basis property, not transferred basis property. It is therefore ineligible for the carryover basis exception of section 101(a)(2)(A).

Accordingly, the proposed regulations are intended to correct the unintended change effected by the final regulations to the treatment under section 101 of a life insurance contract issued to a policyholder in a section 1035 exchange, while continuing to address the concern that the reporting of death benefits paid under section 6050Y(c) could be avoided by exchanging a policy transferred in a reportable policy sale for a new policy in a section 1035 exchange, as well as the concern that a policyholder could attempt to avoid the limitation on the excludability of death benefits resulting from the application of the transfer for value rule through a section 1035 exchange. The proposed regulations would accomplish these objectives by revising the final regulations in four ways.

1. Modify definition of a transfer of an interest in a life insurance contract

First, proposed § 1.101-1(e)(2) would revise the definition of a transfer of an interest in a life insurance contract in § 1.101-1(e)(2) of the final regulations to exclude the issuance of a life insurance contract to a policyholder, without qualification. As such, any issuance of a life insurance contract to a policyholder, including in a section 1035 exchange, is not a transfer of an interest in a life insurance contract and therefore cannot be a reportable policy sale under § 1.101-1(c)(1) of the final regulations. The Treasury Department and the IRS do not view this position as inconsistent with the purpose of section 101(j). See Public Law 109-280, §863(d), 120 Stat. 780, 1024 (2006) (providing that section 101(j) generally applies to life insurance contracts issued after August 17, 2006, “except for a contract issued after such date pursuant to an exchange described in section 1035...for a contract issued on or prior to that date”); Notice 2009- 48, 2009-1 C.B. 1085 (providing that further notice and consent is not required by section 101(j) with regard to a contract received in a section 1035 exchange for an employer-owned life insurance contract issued after August 17, 2006, for which the notice and consent requirements were previously satisfied if either (1) the existing consent remains valid, or (2) the exchange does not result in a material change in the death benefit or other material change in the contract).

The proposed regulations make conforming changes to remove the exception in § 1.101-1(c)(2)(v) of the final regulations (providing that the acquisition of a life insurance contract by a policyholder in a section 1035 exchange 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); to remove §§ 1.6050Y-2(f)(3) and 1.6050Y-3(f)(3) of the final regulations (providing certain reporting requirement exceptions related to section 1035 exchanges that are no longer necessary); and to remove § 1.6050Y-1(a)(8)(ii) of the final regulations (providing a definitional rule related to section 1035 exchanges that is no longer necessary).

2. New rule addressing section 1035 exchanges

Second, proposed § 1.101-1(b)(2)(iv) provides a new rule that would apply to the exchange of an interest in a life insurance contract (old interest) in a section 1035 exchange for an interest in a newly issued life insurance contract (new interest) and provides guidance on how to determine the amount of the proceeds attributable to the new interest that is excludable from gross income under section 101(a), provided the new interest is not subsequently transferred or exchanged. If the new interest is subsequently transferred or exchanged, the amount excludable from gross income under section 101(a) would be determined under the rule in § 1.101-1(b) applicable to the type of transfer or exchange involved. The limitation (or lack of any limitation) on the amount of the proceeds attributable to the old interest that is excludable from gross income applies under proposed § 1.101-1(b)(2)(iv) to the new interest for which it is exchanged, just as the basis of the old interest applies to the new interest. See sections 1031(d) and 1035(d)(2) (providing that a contract acquired in a section 1035 exchange has the same basis as the contract for which it was exchanged). The IRS has previously treated certain attributes of contracts exchanged in section 1035 exchanges as applying to the new contracts acquired. See, e.g., Rev. Rul. 92-95, 1992-2 C.B. 43 (for purposes of section 72(q)(2)(I) and 72(u)(4), the “date of purchase” of an annuity contract acquired in a section 1035 exchange for another annuity contract is the date of purchase of the annuity contract that was exchanged for the new contract). See also section 7702A(a)(2) (defining a modified endowment contract to include any contract exchanged for a contract that is a modified endowment contract under section 7702A(a)(1)).

Proposed § 1.101-1(b)(2)(iv) ensures that the acquirer of an interest in a life insurance contract in a reportable policy sale cannot avoid any limit imposed by section 101(a)(2) and (a)(3) on the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) by simply exchanging the interest for a new life insurance contract. Under proposed § 1.101-1(b)(2)(iv)(A), if the entire amount of the proceeds attributable to the old interest would have been excludable from gross income under section 101(a) at the time of the section 1035 exchange, the entire amount of the proceeds attributable to the new interest is excludable from gross income. Under proposed § 1.101-1(b)(2)(iv)(B), if less than the entire amount of the proceeds attributable to the old interest would have been excludable from gross income under section 101(a) at the time of the section 1035 exchange, the amount of the proceeds attributable to the new interest that is excludable from gross income is limited to the sum of the amount of the proceeds attributable to the old interest that would have been excludable at the time of the section 1035 exchange, and the premiums and other amounts subsequently paid with respect to the new interest by the policyholder. Proposed § 1.101-1(b)(2)(iv)(B) also provides that, when determining the premiums and other amounts subsequently paid by the policyholder with respect to the new interest, the amounts paid by the policyholder are reduced, but not below zero, by amounts received by the policyholder under the new life insurance contract that are not received as an annuity, to the extent excludable from gross income under section 72(e). The proposed regulations also make conforming changes to § 1.101-1(a)(1) of the final regulations and the headings of § 1.101-1(b) and (b)(2) of the final regulations to reflect the addition of proposed § 1.101-1(b)(2)(iv). The proposed regulations also add two examples to illustrate the application of the rules set forth in proposed § 1.101-1(b)(2)(iv). See proposed § 1.101-1(g)(17) and (18).

3. Modification to definition of reportable policy sale

Third, the proposed regulations would modify the definition of “reportable policy sale” to address section 1035 exchanges. Specifically, proposed § 1.101-1(c)(3) addresses situations in which an old interest is exchanged in a section 1035 exchange for a new interest, and the old interest was previously transferred for valuable consideration in a reportable policy sale or is treated, under proposed § 1.101-1(c)(3), as an interest in a life insurance contract that was previously transferred for valuable consideration in a reportable policy sale. In such cases, the new interest is treated, for purposes of § 1.101-1, as an interest in a life insurance contract that was previously transferred for valuable consideration in a reportable policy sale. Under the proposed rule, the old interest’s attribute of having been previously transferred for valuable consideration in a reportable policy sale applies to the new interest acquired in a section 1035 exchange. Whether or not an interest in a life insurance policy was previously transferred in a reportable policy sale is relevant for the purpose of determining the applicability of certain provisions in the final regulations. See, e.g., § 1.101-1(b)(1)(ii)(B)(1) of the final regulations (applies only if the interest was not previously transferred for valuable consideration in a reportable policy sale); § 1.101- 1(b)(1)(ii)(B)(2) and (3) of the final regulations (apply if the interest was previously transferred for valuable consideration in a reportable policy sale); § 1.101-1(b)(2)(i) of the final regulations (includes a special rule for interests that have not previously been transferred for value in a reportable policy sale). The Treasury Department and the IRS have previously treated (and continue to treat) other attributes of contracts exchanged in section 1035 exchanges as applying to the new contracts acquired, so the new contract is treated the same as the old contract. See, e.g., Rev. Rul. 92-95. Similarly, the proposed rule ensures that the new interest is treated the same as the old interest when applying rules that consider whether an interest in a life insurance contract was previously transferred in a reportable policy sale. See proposed § 1.101-1(c)(3). Proposed § 1.101-1(c)(3) also provides that, for purposes of §§ 1.6050Y-3 and 1.6050Y-4, the section 1035 exchange is treated as the transfer of an interest in the life insurance contract in a reportable policy sale if the old interest previously was transferred for valuable consideration in a reportable policy sale (or is treated, under proposed § 1.101-1(c)(3), as an interest in a life insurance contract that previously was transferred for valuable consideration in a reportable policy sale). Accordingly, the designation of death benefits as reportable death benefits is an attribute that transfers from the old interest to the new interest in a section 1035 exchange. See also proposed § 1.6050Y-1(a)(12). The Treasury Department and the IRS previously have treated other attributes of contracts exchanged in section 1035 exchanges as transferring to the new contracts acquired. In this case, the proposed rule ensures that death benefits under the new interest are treated the same as under the old interest for purposes of reporting under section 6050Y(c) and § 1.6050Y-4. These rules are necessary to ensure that the acquirer of an interest in a life insurance contract in a reportable policy sale cannot avoid the designation of the death benefits as reportable death benefits and the associated reporting of the payment of the reportable death benefits by simply exchanging the interest for a new life insurance contract. The proposed regulations also make conforming changes to § 1.101-1(c)(1) of the final regulations to reflect the addition of proposed § 1.101-1(c)(3).

The preamble explains that taxpayers can choose to rely on the proposed regulations – possibly even retroactively to when the reportable policy sale rule first became effective:

> **Applicability Dates**
>
> Proposed §§ 1.101-1(b)(2)(iv) and (c)(3) are proposed to apply to section 1035 exchanges occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register, and proposed § 1.101-1(c)(2)(v) is proposed to apply to any acquisition of an interest in a life insurance contract occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. See proposed § 1.101-6(c). However, it is proposed that a taxpayer may choose to apply § 1.101-1(b)(2)(iv), (c)(2)(v), and (c)(3) of the regulations set forth in the Treasury decision adopting these regulations as final regulations to all section 1035 exchanges and acquisitions occurring after December 31, 2017, and before the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. See section 7805(b)(7) of the Code. Alternatively, a taxpayer may rely on proposed § 1.101- 1(b)(2)(iv), (c)(2)(v), and (c)(3) for all section 1035 exchanges and acquisitions occurring after December 31, 2017, and before the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.
>
> The reporting obligations under proposed § 1.6050Y-3 are proposed to apply to any section 1035 exchange treated as a reportable policy sale under proposed § 1.101-1(c)(3) if the exchange occurs on or after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. See proposed § 1.6050Y-1(b)(2). The reporting obligations under proposed § 1.6050Y-4 are proposed to apply to reportable death benefits paid with respect to an interest in a life insurance contract issued in a section 1035 exchange treated as a reportable policy sale under proposed § 1.101-1(c)(3) if the exchange occurs on or after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. See proposed § 1.6050Y-1(b)(2). Any person with a reporting obligation under proposed § 1.6050Y-3 or proposed § 1.6050Y-4 may, however, rely on the proposed regulations with respect to all section 1035 exchanges occurring after May 10, 2023, and before the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

Reg. § 1.101-1(e)(1), “Definition,” provides:[4400]

> 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

[4400] 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. 4440.

> 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 part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

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

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

> For purposes of this section and section 6050Y, the term transfer of an interest in a life insurance contract means the transfer of any interest in the life insurance contract, including any transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract itself. The creation of an enforceable right to receive all or a part of the proceeds of a life insurance contract constitutes the transfer of an interest in the life insurance contract. The following events are not a transfer of an interest in a life insurance 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:[4401]

> 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

[4401] 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."

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:[4402]

> For purposes of this section and section 6050Y, the acquisition of an interest in a life insurance contract may be direct or indirect.
>
> (i) *Direct acquisition of an interest in a life insurance contract*. For purposes of this section and section 6050Y, the transfer of an interest in a life insurance contract results in the direct acquisition of the interest by the transferee (acquirer).
>
> (ii) *Indirect acquisition of an interest in a life insurance contract*. For purposes of this section and section 6050Y, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest (whether legal or beneficial) in the life insurance contract. For purposes of this paragraph (e)(3)(ii), the term other entity does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts (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:[4403]

> 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

[4402] For the significance of indirect acquisitions under Reg. § 1.101-1(e)(3)(ii), see text accompanying fn. 4442 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. 4409 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.
[4403] 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."

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. 1782.

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[4404] and for whether certain reporting must be done.[4405]

[4404] 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.

[4405] See part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.

The preamble to the proposed regulations explains:[4406]

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

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

Reg. § 1.101-1(c)(1), "In general," provides:[4407]

> 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:[4408]

> 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

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[4406] 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."

[4407] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn. 4402 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

[4408] 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."

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 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:[4409]

(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,

[4409] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn. 4402 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

the prior sentence is applied by comparing the beneficial owners' ownership interest in the first transferor entity and the last transferee entity. For purposes of this paragraph (c)(2)(i), each beneficial owner of a trust is deemed to have an ownership interest determined by the broadest possible exercise of a trustee's discretion in that beneficial owner's favor. Paragraph (g)(13) (Example 13) of this section provides an illustration of the application of this paragraph (c)(2)(i).

(ii) A transfer between corporations that are members of an affiliated group (as defined in section 1504(a)) that files a consolidated U.S. income tax return for the taxable year in which the transfer occurs.

(iii) The indirect acquisition of an interest in a life insurance contract by a person if—

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

(B) Immediately before the acquisition, no more than 50 percent of the gross value of the assets (as determined under paragraph (f)(4) of this section) of the partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract, and in which an ownership interest is being directly acquired, consists of life insurance contracts, provided that, after the acquisition, with respect to that 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.[4410] 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.)[4411]

Reg. § 1.101-1(c)(2)(i) refers to Reg. § 1.101-1(g)(13),[4412] 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)[4413] elaborates on Reg. § 1.101-1(c)(2)(iii)(B), providing:

> *Example 15*. The facts are the same as in Example 14[4414] 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

[4410] For the preamble discussing this issue, see fn. 4399 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

[4411] See Reg. § 1.101-1(d)(2)(ii).

[4412] 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....

[4413] 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....

[4414] [Not in the regulation - click to go to:] Example 14.

> 50% of Partnership X's asset value consists of life insurance contracts, the exception in paragraph (c)(2)(iii)(B) of this section applies, and B's indirect acquisition of an interest in the policy covering A's life is not a reportable policy sale.

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

The preamble to the proposed regulations explains:[4415]

> 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

[4415] 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**
>
> 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.[4416] 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.”[4417] 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

[4416] [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.
[4417] [my footnote:] ACTEC Fellow Michael Van Cise was that commenter.

the charitable organization's services in some manner.[4418] 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.

[4418] [my footnote:] I was that commenter; see fn. 4416.

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. 4366-4368 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)[4419] 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)[4420] 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

[4419] 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....

[4420] 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.

Prop. Reg. § 1.101-1(g)(17)[4421] elaborates on Prop. Reg. § 1.101-1(b)(2)(iv), providing:

> *Example 17*. The facts are the same as in Example 4 in paragraph (g)(4) of this section except that, before A's death, C exchanges the policy on A's life for a new policy on A's life in a section 1035 exchange. The amount of the proceeds C may exclude from C's gross income under this section is limited under paragraph (b)(2)(iv)(B) of this section to $6,000 plus any premiums and other amounts paid by C with respect to the original policy subsequent to the transfer and any premiums and other amounts paid by C with respect to the new policy subsequent to the exchange.

Prop. Reg. § 1.101-1(g)(18)[4422] elaborates on Prop. Reg. § 1.101-1(b)(2)(iv), providing:

> *Example 18*. The facts are the same as in Example 17 in paragraph (g)(17) of this section except that, before A's death, C sells the new policy to A for fair market value. A's estate receives the proceeds of $100,000 on A's death. Under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds A's estate may exclude from gross income is not limited by paragraph (b) of this section.

Prop. Reg. § 1.101-1(g)(19)[4423] provides:

> *Example 19*. 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 at the time of the transfer. The transfer from A to C is a reportable policy sale. C also is the initial policyholder of a $200,000 insurance policy on A's life. Before A's death, C exchanges the two policies on A's life for a single new policy on A's life in a section 1035 exchange. C receives the proceeds from the new policy on A's death. The entire amount of the proceeds attributable to the interest in the new policy that was issued in exchange for

[4421] See retroactivity provided in Applicability Dates of the proposed regulations. 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....

[4422] See retroactivity provided in Applicability Dates of the proposed regulations. 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....

[4423] See retroactivity provided in Applicability Dates of the proposed regulations. Reg. § 1.101-1(g), "Examples," begins with:

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

the policy originally issued to C is excludable from gross income under paragraph (b)(2)(iv)(A) of this section. The amount of the proceeds attributable to the interest in the new policy that was issued in exchange for the policy originally issued to A that is excludable from gross income is limited under paragraph (b)(2)(iv)(B) of this section to $6,000 plus any premiums and other amounts paid by C with respect to the policy originally issued to A subsequent to the transfer and any premiums and other amounts paid by C with respect to the interest in the new policy that was issued in exchange for the policy originally issued to A.

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:[4424]

> 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

[4424] 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."

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 would have been excludable by the transferor, and (2) the premiums and other amounts subsequently paid by the transferee.

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

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

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

The proposed regulations provide a single rule applicable to all gratuitous transfers of interests in life insurance contracts, including reportable policy sales that are not for valuable consideration: the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of (1) The

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

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

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

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

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

(2) *Transfers to certain persons subsequent to a reportable policy sale*. Except as provided in paragraph (b)(1)(ii)(B)(3) of this section, if a transfer of an interest in a life insurance contract would be described in paragraph (b)(1)(ii)(B)(/) of this section, but for the fact that the interest previously was transferred for valuable consideration in a reportable policy sale (whether in the immediately preceding transfer or an earlier transfer), then the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of -

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

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

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

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

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

Reg. § 1.101-1(b)(1)(ii)(B)(1) above continues the policy of the prior regulations that a transfer to a permitted transferee cleanses a prior transfer for value, but it adds in the requirement that the transfer not be a reportable policy and removes the requirement that the transfer be the final transfer before the insured's death.[4425]

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.[4426]

Examples (10) through (12) in Reg. § 1.101-1(g)(10) through(12)[4427] shed some light on this rule (other than the cleansing aspects, which are discussed later:

> (10) *Example 10*. A is the initial policyholder of a $100,000 insurance policy on A's life. A contributes the policy to Corporation X in exchange for stock. Corporation X's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. Corporation X conducts an active trade or business that it wholly owns, and A materially participates in that active trade or business as an employee of Corporation X. Corporation X receives the proceeds of $100,000 on A's death. A's contribution of the policy to Corporation X is not a reportable policy sale because Corporation X has a substantial business relationship with A under paragraph (d)(2)(i) of this section. Although Corporation X's basis in the policy is determinable in whole or in part by reference to A's basis in the policy, paragraph (b)(1)(ii)(A) of this section does not apply because the insured, A, is a shareholder of Corporation X and the other requirements under paragraph (b)(1)(ii)(B) of this section are satisfied. Accordingly, paragraph (b)(1)(ii)(B) of this section applies, and paragraph (b)(1)(ii)(A) of this section is inapplicable. Under paragraph (b)(1)(ii)(B)(/) of this section, Corporation X's exclusion is not limited by paragraph (b) of this section.
>
> (11) *Example 11*. The facts are the same as in Example 10 in paragraph (g)(10) of this section, except that Corporation X transfers its active trade or business and the policy on A's life to Corporation Y in a tax-free reorganization at a time when A is still employed by Corporation X, but is no longer a shareholder of Corporation X. Corporation Y's basis in the policy is determinable in whole or in part by reference to Corporation X's basis in the policy, and Corporation Y carries on the trade or business acquired from Corporation X. Corporation Y receives the proceeds of $100,000 on A's death. The transfer from Corporation X to Corporation Y is not a reportable policy sale because Corporation Y has a substantial business relationship with A under paragraph (d)(2)(ii) of this section. The amount of the proceeds that Corporation Y may exclude from gross income is limited under paragraph (b)(1)(ii)(A) of this section to the sum of the amount that would have been excludable by Corporation X had the transfer to Corporation Y not occurred, plus any premiums and other amounts paid by Corporation Y with respect to the policy subsequent to the transfer. Accordingly, because Corporation X's exclusion is

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4425 Reg. § 1.101-1(b)(1)(ii)(B)(1) is applied is Example (3), which is discussed in the text accompanying fn. 4431 in part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.

4426 Especially text accompanying fn. 4435.

4427 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....

not limited by paragraph (b) of this section, as described in Example 10 in paragraph (g)(10) of this section, Corporation Y's exclusion is not limited by paragraph (b) of this section.

(12) *Example 12*. A is the initial policyholder of a $100,000 insurance policy on A's life. A contributes the policy to a C corporation, Corporation W, in exchange for stock. After 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)[4428] 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

[4428] 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....

B may exclude from B's gross income under this section is limited under paragraph (b)(1)(i) of this section to $6,000 plus any premiums and other amounts paid by B with respect to the policy subsequent to the transfer.

(2) *Example 2*. The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B gratuitously transfers the policy back to A. A's estate receives the proceeds of $100,000 on A's death. Because the transfer from B to A is 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)(/) of this section applies to the transfer to A, and the amount of the proceeds A's estate may exclude from gross income is not limited by paragraph (b) of this section.

Before discussing cleansing, let's discuss Example (1). If A had given the policy to B, then the gift would have qualified for the substituted basis exception to the transfer for value rule. If A had sold the policy to an irrevocable grantor trust that A had previously established for B, the sale would have been disregarded and the rule would not have applied.[4429]

Example (2) cleansed the policy by a gratuitous transfer to the insured under Reg. § 1.101-1(b)(2)(i).[4430]

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).[4431] 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)[4432] in the proposed regulations asserted that no transfer back to the insured will cleanse the policy

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[4429] See Rev. Rul. 2007-13, reproduced in fn. 4384 in part II.Q.4.b.i Transfer for Value Rule Generally.
[4430] Fn. 4436 reproduces the relevant part of Reg. § 1.101-1(b)(2)(i), and Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn. 4397 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.
[4431] See text accompanying and preceding fn. 4425 in part II.Q.4.b.ii.(d) Transfer With Substituted Basis or To Permitted Transferee When Not a Reportable Policy Sale.
[4432] 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....

from the transfer for value rules, but the final regulations allow a fair market value sale to the insured to cleanse the policy:

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

(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)[4433] 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

[4433] 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

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

(i) *Treatment of policy interest purchased by A*. A's estate may exclude from income all of the policy proceeds related to the 50% policy interest transferred for valuable consideration ($50,000) because, under paragraph (b)(1)(ii)(B)(3)(i) of this section, 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)[4434]:

(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

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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....

[4434] 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 (b)(1)(ii)(B)(3)(ii) of this section, the amount of the policy proceeds excludable from gross income by B is determined under paragraph (b)(2)(i) of this section, taking into account the application of paragraph (b)(1)(ii)(B)(3)(i) of this section to A's acquisition of the interest. Under paragraph (b)(2)(i) of this section, the amount of the proceeds B may exclude is limited to the sum of the amount A could have excluded had the transfer to B not occurred, and any premiums and other amounts paid by B with respect to the policy subsequent to the transfer to B. As described in Example 6 in paragraph (g)(6) of this section, under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds that A may exclude from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section. Accordingly, the amount of the proceeds that B may exclude from gross income is not limited by paragraph (b) of this section.

(ii) *Treatment of policy interest transferred to E*. With respect to the portion of the policy interest transferred to E, because the transfer to E was not gratuitous and was a reportable policy sale, under paragraph (b)(1)(ii)(B)(3)(ii) of this section, the 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.[4435] 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."[4436] 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

[4435] Reg. § 1.101-1(b)(1)(ii)(B)(3) is reproduced in the text preceding fn. 4426.

[4436] Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn. 4397 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

(b) The premiums and other amounts subsequently paid by him;

(ii) If the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee shall exclude the entire amount of the proceeds from gross income;

(iii) Except where subdivision (ii) of this subparagraph applies, if the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the final transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest therein in the hands of the transferor, the amount of the proceeds which is excludable by the final transferee is limited to the sum of—

(a) The amount which would have been excludable by his transferor if no such transfer had taken place, and

(b) Any premiums and other amounts subsequently paid by the final transferee himself.

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 narrower 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).[4437]

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).[4438]

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."[4439] 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

[4437] [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).
[4438] [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).
[4439] Code § 101(a)(2).

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,"[4440] an "interest" refers to taking "title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes," as well as holding "an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other economic benefits of the policy" as described in Reg. § 20.2042-1(c)(2) (incidents of ownership).

Applying the above definition of an "interest" in a contract, it appears that for purposes of testing whether a transfer for value has occurred that may affect the exclusion of a death benefit from income, direct ownership of a policy (in whole or in part) must be subjected to a "transfer for a valuable consideration."[4441] 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.[4442] 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:[4443]

> 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.[4444] Otherwise, one may need to file Form 1099-LS for each

[4440] Reg. § 1.101-1(e)(1) is reproduced in the text accompanying fn. 4400.
[4441] For a discussion of legislative history supporting this idea, see fn. 4393 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.
[4442] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn. 4402 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. 4409 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.
[4443] 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. 4409 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.
[4444] 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. 4409 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

policy, to qualify for the exception for a reportable policy sale reported in compliance with Code § 6050Y(a) and Reg. § 1.6050Y-2.

Although I feel comfortable taking the position that the rule regarding indirect acquisitions does not cause the transfer of an interest in a business entity to be a transfer for value, the IRS might assert that such a position makes the reportable policy sale rule toothless for income tax purposes, because all one needs to do to protect a life insurance contract from the income tax consequences is to put the life insurance in a partnership wrapper. Thus, the IRS' might argue that an "indirect acquisition" constitutes a "a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein."[4445]

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

REG-108054-21, Information Reporting and Transfer for Valuable Consideration Rules for Section 1035 Exchanges of Life Insurance and Certain Other Life Insurance Contract Transactions (5/09/2023) describes how the regulations it proposes softens the approach to corporation reorganizations:[4446]

> *Ordinary Course Trade or Business Acquisitions*
>
> As noted in the preamble to the final regulations, 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 because a corporate level income tax applies to corporate earnings in addition to income tax on distributions at the shareholder level. See 84 FR 58460, 58467. After consideration of the comments and letter received on the 2019 proposed regulations and the final regulations, respectively, regarding ordinary course trade or business acquisitions, the Treasury Department and the IRS are proposing an exception for certain direct acquisitions of interests in life insurance contracts from a C corporation.
>
> Proposed § 1.101-1(c)(2)(v) provides that the direct acquisition of an interest in a life insurance contract from a C corporation by a C corporation is not a reportable policy sale if (1) the acquisition results from a transaction that qualifies as a reorganization under section 368(a); (2) immediately before the acquisition, (i) the interest is held by a C corporation that conducts an active trade or business within the meaning of § 1.367(a)-2(d)(2) and (3), (ii) the C corporation does not engage in a trade or business of investing in interests in life insurance contracts, and (iii) no more than 5 percent of the gross value of the assets of the C corporation consists of life insurance contracts; and (3) immediately after the acquisition, (i) the acquiring C corporation does not engage in a trade or business of investing in interests in life insurance contracts, and (ii) not more than 5 percent of the gross value of the assets of the C corporation consists of life insurance contracts. This exception would provide relief from the reportable policy sale rules for acquisitions of interests in life insurance contracts through certain ordinary course trade or business acquisitions while preserving different treatment for direct and

[4445] Code § 101(a)(2).
[4446] **Applicability Dates** are found in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

indirect acquisitions of interests in life insurance contracts in other cases. The proposed regulations modify Example 11 in § 1.101-1(g)(11) of the final regulations to reflect the addition of the exception in proposed § 1.101-1(c)(2)(v). See proposed § 1.101-1(g)(11).

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.[4447] 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,[4448] 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.

Rev. Rul. 2020-5 modifies Rev. Ruls. 2009-13 and 2009-14 to effectuate Code § 1016(a)(1)(B).[4449]

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; Code § 1035

Generally, income tax applies when buying, selling, or swapping policies. However, Code § 1035, "Certain exchanges of insurance policies," provides:

> (a) *General rules*. No gain or loss shall be recognized on the exchange of -
>
> (1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract or for a qualified long-term care insurance contract;
>
> (2) a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (B) for an annuity contract, or (C) for a qualified long-term care insurance contract;
>
> (3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or

[4447] See Rev. Ruls. 2009-13 and 2009-14. Commentators disagreed with the IRS' position.

[4448] 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.

[4449] For details on Rev. Rul. 2020-5, see text accompanying fn. 4454.

(4) a qualified long-term care insurance contract for a qualified long-term care insurance contract.

(b) *Definitions*. For the purpose of this section -

(1) *Endowment contract*. A contract of endowment insurance is a contract with an insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

(2) *Annuity contract*. An annuity contract is a contract to which paragraph (1) applies but which may be payable during the life of the annuitant only in installments. For purposes of the preceding sentence, a contract shall not fail to be treated as an annuity contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.

(3) *Life insurance contract*. A contract of life insurance is a contract to which paragraph (1) applies but which is not ordinarily payable in full during the life of the insured. For purposes of the preceding sentence, a contract shall not fail to be treated as a life insurance contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.

(c) *Exchanges involving foreign persons*. To the extent provided in regulations, subsection (a) shall not apply to any exchange having the effect of transferring property to any person other than a United States person.

(d) *Cross references*.

(1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

Reg. § 1.1035-1(c) provides, "section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured."[4450] 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).

[4450] Some tax research services make this clause look like part of subsection (c) only, but T.D. 6211 (11/14/56) clearly indents (a), (b), and (c) without indenting this part.

> In the present situation, X exercised an option in its key person insurance policy that permitted it to change the insured from A, the original insured under the policy, to B, the new insured. This resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the life that is insured under the contract. Thus, X's exercise of the change-of-insureds option is substantively the same as an actual exchange of contracts and is a sale or other disposition for purposes of section 1001.
>
> Section 1.1035-1 of the regulations expressly excludes from the application of section 1035 exchanges of policies that do not relate to the same insured and thus prevents policy owners from deferring indefinitely recognition of gain with respect to the policy value. Had X actually assigned a life insurance policy on A to the insurance company as consideration for a new life insurance policy on B, any gain realized on the exchange would have been ineligible for nonrecognition treatment under section 1035 of the Code. X cannot avoid the same-insured limitations of section 1035 simply by placing terms in its original documents that obviate the need for an actual exchange but nevertheless effect a de facto exchange of the original contract for a new contract on a different insured. For example, the result would be the same if X insured a person holding a particular position and, thus, no formal substitution is made when a new person occupies that position.

It held:

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

A taxpayer may roll over part of a policy into another policy. 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).

Similarly, Rev. Rul. 92-43 held that a taxpayer's exchange of an annuity contract issued by a life insurance company that has become subject to a rehabilitation, conservatorship, or similar state proceeding, for an annuity contract issued by another life insurance company qualify as tax-free under Code § 1035 if the new contract is funded by a series of two or more payments from the old annuity contract, even in the case of serial funding of a new life insurance contract. Its facts were:

> L1 is a life insurance company within the meaning of section 816(a) of the Code. L1 is domiciled in state O. A owns an annuity contract (Old Contract) issued by L1.
>
> L1 is subject to a O rehabilitation, conservatorship, or similar state proceeding under the jurisdiction and control of the O insurance commissioner and a O court. Under the terms

> imposed by any O authorities pursuant to the proceeding, L1 is permitted to distribute no more than X percent of the full cash value of the annuity contract. A wishes to terminate all of A's rights in Old Contract and acquire a new annuity contract (New Contract) from L2. L2 is a life insurance company within the meaning of section 816(a) of the Code.
>
> A assigns Old Contract to L2 in exchange for a New Contract. Pursuant to the assignment, L1 pays cash to L2 in an amount that represents X percent of the cash value of Old Contract, and is required to pay L2 an amount equal to any residual value of Old Contract when it is permitted to do so by the O authorities. L2 must credit to New Contract all amounts received from L1.

Rev. Rul. 92-43 reasoned:

> Section 1035(a)(3) of the Code provides that no gain or loss is recognized on the exchange of one annuity contract solely for another annuity contract. Neither the statute nor the regulations contain a time limit for completion of the exchange. In addition, nonrecognition treatment under section 1035 is not expressly conditioned upon the relative policy values of the contracts exchanged, so long as no other property or cash is distributed as part of the exchange.
>
> Under the facts described, A has effected an exchange of annuity contracts. Because section 1035(a)(3) of the Code does not require that an exchange be completed concurrently where the issuer is precluded from distributing the full cash value of the contract, the transaction is a nontaxable exchange of an annuity contract for an annuity contract under that section.

Rev. Rul. 92-43 held:

> Under section 1035 of the Code, A does not recognize gain or loss on the exchange of Old Contract for New Contract even though New Contract will be funded through a series of payments from L1 that may extend over a period of time. The same holding applies in the case of serial funding of an exchange of a life insurance contract for a life insurance, endowment, or annuity contract.

Letter Ruling 200323012 held that a revocable trust could swap tax-free under Code § 1035 two annuity contracts it owned on the life of its deemed owner for one annuity contract that owner owned on her life.[4451]

A life insurance contract may be swapped into another life insurance, endowment, annuity, or qualified long-term care insurance contract. 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

[4451] Letter Ruling 200323012 is discussed (including large excerpts) in part II.J.19.a.v Annuity Contract Issued to Grantor Trust in the text before and after fn. 3063.

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 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.

If one insured in a second-to-die policy has died, Code § 1035 may apply to the exchange of that policy for a policy on the life of only the surviving insured. 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).

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. 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.

The transfer for value rule might cause the death benefit to be subject to income tax. see part II.Q.4.a Funding the Buy-Sell.

When life insurance is sold in a taxable transaction, the IRS' position was that:[4452]

[4452] Rev. Rul. 2009-13, Situation 2 provides the following facts and analysis, which works from Situation 1:

> **Situation 1**
>
> On January 1 of Year 1, A, an individual, entered into a life insurance contract (as defined in § 7702 of the Internal Revenue Code (Code)) with cash value. Under the contract, A was the insured, and the named beneficiary was a member of A's family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract in A's hands was not property described in § 1221(a)(1)-(8).

On June 15 of Year 8, A surrendered the contract for its $78,000 cash surrender value, which reflected the subtraction of $10,000 of cost-of-insurance charges collected by the issuer for periods ending on or before the surrender of the contract. Through that date, A had paid premiums totaling $64,000 with regard to the life insurance contract. A had neither received any distributions under the contract nor borrowed against the contract's cash surrender value.
A determines taxable income using the cash method of accounting and files income tax returns on a calendar year basis. As of June 15 of Year 8, A was not a terminally ill individual, nor a chronically ill individual, within the meaning of § 101(g)(4).

Situation 2

The facts are the same as in Situation 1, except that on June 15 of Year 8, A sold the life insurance contract for $80,000 to B, a person unrelated to A and who would suffer no economic loss upon A's death.

….

Law and Analysis

….

In Situation 2, A paid total premiums of $64,000 under the life insurance contract through the date of sale, and $10,000 was subtracted from the contract's cash surrender value as cost-of-insurance charges. Accordingly, A's adjusted basis in the contract as of the date of sale under §§ 1011 and 1012 and the authorities cited above was $54,000 ($64,000 premiums paid less $10,000 expended as cost of insurance).
Accordingly, A must recognize $26,000 on the sale of the life insurance contract to B, which is the excess of the amount realized on the sale ($80,000) over A's adjusted basis of the contract ($54,000).
[above two paragraphs were superseded by Rev. Rul. 2020-5, as described in fn. 4454.]

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 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

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"),[4453] and

    - Capital gain to the extent of the balance.

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

However, as mentioned above, Congress retroactively repealed the IRS' position that the selling taxpayer's basis is reduced by the cost of insurance.[4454]

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.[4455] Rev. Rul. 2009-14 discusses tax consequences to the purchaser of a term life insurance policy but must be read in light of the modification to Situation 2 made by Rv. Rul. 2020-5.

Using a life insurance LLC might solve most or all of these issues.[4456]

> 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).

[4453] 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. 4469.

[4454] See text accompanying fn. 4449 in part II.Q.4.b.iii Basis in Purchased Life Insurance Contract. Thus, Rev. Rul. 2020-5 modifies the analysis of fn. 4452:

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

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

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

[4455] Rev. Rul. 2009-13, Situation 1.

[4456] 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.

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,[4457] the rules described below do not apply.[4458]

Generally, distributions (other than tax-free death benefits) from life insurance contracts are not taxable "the extent allocable to the investment in the contract."[4459] Dividends used to pay premiums are not taxable.[4460] 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[4461] and are treated as distributions when those exceptions apply.[4462] 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.[4463]

Furthermore, gifts or trust distributions may trigger income taxation. Code § 72(e)(4)(C), "Treatment of transfers without adequate consideration," provides:

> (i) *In general*. If an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of -
>
> (I) the cash surrender value of such contract at the time of transfer, over
>
> (II) the investment in such contract at such time,
>
> under the contract as an amount not received as an annuity.
>
> (ii) *Exception for certain transfers between spouses or former spouses*. Clause (i) shall not apply to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.
>
> (iii) *Adjustment to investment in contract of transferee*. If under clause (i) an amount is included in the gross income of the transferor of an annuity contract, the investment in the contract of the transferee in such contract shall be increased by the amount so included.

4457 Code § 101(a)(1).

4458 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.

4459 Code § 72(e)(5)(C) applies the Code § 72(e)(5)(A) rule of nontaxable recovery of investment coming first.

4460 Code § 72(e)(4)(B).

4461 Code § 72(e)(4)(A) includes various exceptions.

4462 Code § 72(e)(4)(A) includes various exceptions.

4463 Code § 72(e)(10), using the definition of modified endowment contract in Code § 7702A.

Consider whether turning off grantor trust status, whether voluntarily or by reason of death, might trigger Code § 72(e)(4)(C) income taxation.

Kitces, "Owning Deferred Annuities In Trusts And Preserving Tax-Deferral Treatment" (12/25/2013), explains:

> Ironically, in situations where an annuity is transferred out of a trust, the transaction also does not trigger IRC Section 72(e)(4)(C), as the IRS reads the provision literally, and since it states that it must be "an individual who holds an annuity..." a trust that owns the annuity in the first place isn't an individual and therefore cannot trigger tax treatment by transferring the contract. Thus, in PLR 201124008, where an annuity was distributed in-kind by a bypass trust to its trust natural person trust beneficiary, the transfer was not taxable at the time.
>
> However, in situations where the annuity is being transferred as a (taxable) gift to a trust, the situation is less clear. If the trust is not a grantor trust and the transfer is a gift, IRC Section 72(e)(4)(C) will clearly be triggered, even if all the beneficiaries are natural persons such that subsequent gains may again be tax-deferred once the trust owns the annuity. Perhaps the most confusing situation is when an annuity is transferred to an Intentionally Defective Grantor Trust (IDGT), which is a grantor trust for income tax purposes but outside of the individual's estate for gift and estate tax purposes. While some have contended that the transfer of the annuity to the IDGT should not trigger taxation upon transfer - it certainly wouldn't face ongoing under 72(u) since it's a grantor trust - it's difficult to claim that the annuity was not "a transfer without full and adequate consideration" when the grantor has to file a gift tax return to report the transfer in the first place! Notably, while popular Revenue Ruling 85-13 has indicated that a sale of property to a grantor trust should not trigger gain, as one cannot have a sale between a grantor and the grantor's trust, in this case the problem is actually that the annuity was not sold but gifted as a gratuitous transfer (without full and adequate consideration). Ironically, this suggests that while a sale of an annuity to an IDGT might avoid gains treatment, the gratuitous gift transfer of an annuity to an IDGT may trigger gain. Unfortunately, though, neither situation has been directed address on point in a Tax Court case or even via a Private Letter Ruling.

Any distributions in excess of "investment in the contract" constitute ordinary income.[4464] However, Code § 1234A might be used to argue that income on surrender should be all capital gain.[4465]

"Investment in the contract":[4466]

> as of any date is-
>
> (A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus

[4464] Code § 72(e)(2).
[4465] 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.
[4466] Code § 72(e)(6).

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

However, charges relating to a long-term insurance component of a policy may reduce "investment in the contract."[4467]

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.

[4467] 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).

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

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

Consider the following potential abuse:

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

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

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

Given that the buyer has no risk, a policy owner could easily find a straw man to help the policy owner cash in the policy and receive capital gain treatment, avoiding the ordinary income treatment provided by Code § 72(e)(1). Rev. Rul. 2009-13,[4468] Situation 2,[4469] 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.[4470]

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[4471] 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[4472]) receives a new tax basis when that individual dies if that property is included in that individual’s estate for estate tax purposes.[4473]

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.

[4468] See fn. 4448 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.
[4469] See fn. 4452.
[4470] See text accompanying fn. 4452.
[4471] Code § 101(a)(2).
[4472] 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.
[4473] 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

"Annuities described in section 72" do not receive a new basis.[4474] 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; see part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up. Reg. § 1.691(a)-1(b) provides:

> **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."[4475] 2017 tax reform modified this test; a brief explanation is in the "SUPPLEMENTARY INFORMATION" portion of the preamble to T.D. 9941 (1/6/2021):[4476]

> **Background**
>
> This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 451(b) and (c) of the Internal Revenue Code (Code).
>
> On December 22, 2017, section 451(b) and (c) were amended by section 13221 of Public Law 115-97 (131 Stat. 2054), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 451(b) was amended to provide that, for a taxpayer using an accrual method of accounting (accrual method taxpayer), the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included in revenue for financial accounting purposes on an applicable financial statement (AFS). Section 451(c) was amended to provide that an accrual method taxpayer may use the deferral method of accounting provided in section 451(c) for

[4474] Code § 1014(b)(9); Reg. § 1.1014-2(b)(3)(i).

[4475] 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.

[4476] One provision makes death trigger income tax regarding inventory; see part III.A.6 Post-Mortem Trust and Estate Administration.

advance payments. Unless otherwise indicated, all references to section 451(b) and section 451(c) hereinafter are references to section 451(b) and section 451(c), as amended by the TCJA.

I. Section 451(b)

In general, section 451(a) provides that the amount of any item of gross income is included in gross income for the taxable year in which it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Under § 1.451-1(a), accrual method taxpayers generally include items of income in gross income in the taxable year when all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (all events test). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. Revenue Ruling 2003-10, 2003-1 C.B. 288; Revenue Ruling 84-31, 1984-1 C.B. 127; Revenue Ruling 80-308, 1980-2 C.B. 162.

Section 451(b)(1)(A) provides that, for an accrual method taxpayer, the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included as revenue in an AFS (AFS Income Inclusion Rule).

Section 451(b)(1)(B) lists exceptions to the AFS Income Inclusion Rule. The AFS Income Inclusion Rule does not apply to taxpayers that do not have an AFS for a taxable year or to any item of gross income from a mortgage servicing contract.

Section 451(b)(1)(C) codifies the all events test, stating that the all events test is met for any item of gross income if all the events have occurred which fix the right to receive such income and the amount of such income can be determined with reasonable accuracy.

Section 451(b)(2) provides that the AFS Income Inclusion Rule does not apply for any item of gross income the recognition of which is determined using a special method of accounting, “other than any provision of part V of subchapter P (except as provided in clause (ii) of paragraph (1)(B)).”

Section 451(b)(3) defines an AFS, as referenced in section 451(b)(1)(A)(i), by providing a hierarchical list of financial statements.

Section 451(b)(4) provides that for purposes of section 451(b), in the case of a contract which contains multiple performance obligations, the allocation of the transaction price to each performance obligation is equal to the amount allocated to each performance obligation for purposes of including such item in revenue in the taxpayer’s AFS.

Section 451(b)(5) provides that, if the financial results of a taxpayer are reported on the AFS for a group of entities, the group’s financial statement shall be treated as the AFS of the taxpayer.

II. Section 451(c)

Section 451(c) provides special rules for the treatment of advance payments. Section 451(c)(1)(A) provides the general rule requiring an accrual method taxpayer to include an advance payment in gross income in the taxable year of receipt. However, section 451(c)(1)(B) permits a taxpayer to elect to include any portion of the advance payment in gross income in the taxable year following the year of receipt to the extent income is not included in revenue in the AFS in the year of receipt. Section 451(c)(1)(B) generally codifies Revenue Procedure 2004-34, 2004-22 I.R.B. 991, which provided for a similar deferral period.

Section 451(c)(2)(A) provides the Secretary of the Treasury or his delegate (Secretary) with the authority to provide the time, form and manner for making the election under section 451(c)(1)(B), and the categories of advance payments for which an election can be made. Under section 451(c)(2)(B), the election is effective for the taxable year that it is first made and for all subsequent taxable years, unless the taxpayer receives the consent of the Secretary to revoke the election. Section 451(c)(3) provides that the deferral election does not apply to advance payments received in the taxable year that the taxpayer ceases to exist.

Section 451(c)(4)(A) defines advance payment for purposes of section 451(c). Under section 451(c)(4)(A), the term advance payment means any payment that meets the following three requirements: (1) The full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting; (2) any portion of the advance payment is included in revenue in an AFS for a subsequent tax year; and (3) the advance payment is for goods, services, or such other items that the Secretary has identified. Section 451(c)(4)(B) lists certain payments that are excluded from the definition of advance payment and gives the Secretary the authority to identify other payments to be excluded from the definition. Section 451(c)(4)(C) provides a special definition of the term "receipt" for purposes of the definition of advance payment, and section 451(c)(4)(D) states that rules similar to those for allocating the transaction price among performance obligations in section 451(b)(4) also apply for purposes of section 451(c).

IRD does not include "items which are excluded from gross income under subtitle A."[4477]

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)[4478] or excluded from income (if received as a nontaxable death benefit).[4479] 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.

[4477] Reg. § 1.691(a)-1(c).
[4478] Code § 72(e).
[4479] See fns. 4457-4458.

This analysis is consistent with a test the Tax Court formulated for determining whether proceeds from a sale contract are IRD. The test considers:[4480]

[4480] *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").

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

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

[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:[4481]

> 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:[4482]

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

(Related to this is the "open transaction" doctrine. See part II.A.1.d.ii Monetizing Founder's Remaining Shares After Going Public, discussing the prepaid variable forward Tax Court case of *Estate of Andrew J. McKelvey v. Commissioner*). Also, the IRS has unsuccessfully attempted to use the tax benefit rule (see part II.G.4.m.iii Tax Benefit Rule) to circumvent any protection provided above.[4483]

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

[4481] 74 T.C. at 643-44.
[4482] 74 T.C. at 641. In a case involving a similar issue, farm inputs deducted on the decedent's final returns received a basis step-up at death and could be deducted by his widow on her return, even though their expected use was obvious. See *Backemeyer*, discussed in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.
[4483] See text accompanying fn. 6679 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

that will never decrease. Rev. Rul. 2009-13[4484] 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.[4485] 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),[4486] do not constitute IRD unless actually sold before death; an asset's character as an ordinary income asset has nothing to do with IRD characterization unless the income is "accrued"[4487] 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.[4488] 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,[4489] so my mention of it simply provides context in which to analyze these issues.

[4484] See fn. 4448 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.

[4485] See fn. 4452.

[4486] Code § 1221(a)(1) provides:

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

Note that real estate might or might not constitute inventory. See part II.G.26.c Future Development of Real Estate.

[4487] 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.

[4488] For example, nobody has ever suggested that a depreciable building used in a business is not eligible for a new basis under Code § 1014, even though Code § 1221(a)(2) provides that such a building is not a capital asset. See*, e.g.*, Reg. §§ 1.1245-2(c)(1)(iv) and 1.1250-3(b)(2)(i), providing that Code § 1014 can wipe out depreciation recapture when such property is included in the deceased owner's estate. See also the quotes from the U.S. Supreme Court and Tax Court in the text accompanying fn. 2117, found in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[4489] See fn. 4448 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.

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.[4490]

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[4491] do not make the death benefit taxable.[4492]

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,

[4490] 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 plan, does not receive a basis step-up at death to the extent of that NUA. This ruling preceded *Peterson* (fn. 4480), and I believe it is simply wrong in light of *Peterson*, because there is no assurance that the gain will ever be realized, and the ruling did not cite any particular support in reaching the conclusion it did. It is also philosophically inconsistent with the IRS' failure to assert assignment of income principles or otherwise impose any taint when NUA property was given to charitable remainder trusts in Letter Rulings 200038050, 200202078, 200215032, 200302048, and 200335017.

[4491] See part II.Q.4.a Funding the Buy-Sell, especially fns. 4376-4388.

[4492] 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.

> Dad owns policy on Daughter's life. Dad dies. Dad's estate sells the policy to Son, violating the transfer for value rules (unless an exception applies) and triggering the insurance company tracking the new "investment in the contract." Then Son sells the policy to Daughter (the insured); this transaction would not generate any gain to the extent of Son's basis due to his purchase from Dad's estate, and Daughter's purchase cleanses the transfer-for-value taint because she is the insured. However, one might decide that taking all these steps is not worth the effort and simply ask whether the insurance company will honor a request to check the box "taxable amount not determined."

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

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

A split-dollar arrangement is an arrangement in which one party pays part or all of the premiums and one or more of the economic rights to the policy (cash value, death benefits, etc.) are divided. An employer cannot bundle together a number of such arrangements and call them deductible welfare benefit plans; doing so subjects the employer to penalties.[4493] If an employer buys insurance on an employee's life and allows the employee to designate the beneficiary, that arrangement may constitute an ERISA plan.[4494] The IRS has an audit techniques guide on split-dollar arrangements.[4495]

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.[4496] 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

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[4493] *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).

[4494] And it did in *Alberth v. Southern Lakes Plumbing & Heating, Inc.*, 2020 WL 1082775, 2020 Employee Benefits Cas. 84,566 (E.D. Wis. 3/6/2020) (Docket No. 19-CV-62).

[4495] 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.

[4496] The reimbursement obligation was nonrecourse – paid only out of the policy and not personally by the employee.

the annual life insurance protection became too high as the employee got older, because the parties wanted to simplify the arrangement, or termination of employment. Often, the policy's cash value exceeded the premiums paid; and some taxpayers took the position that receipt of the life insurance policy, which had a cash value in excess of the premiums reimbursed to the employer on rollout, was not a taxable event, because the employee (or life insurance trust) already had legal title to the policy. The government was not happy with the taxpayer using the tax fiction of the employer owning the policy before rollout and then ignoring that tax fiction at rollout and responded by promulgating the regulatory regime described below.

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

In the economic benefit regime, generally the owner and non-owner receive tax-free death benefits. The owner applies Code § 72 to any distributions that are not death benefits; even a deemed owner is treated as the real owner under Code § 72. See part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement. The other version involves the premium payor being treated as making loans to the policy owner. Generally, interest is actually paid when the insured dies but treated as paid every year,[4497] and the parties need to make an election to give effect to the loan for income and gift tax purposes.[4498] 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[4499] 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

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[4497] Stated interest that is not payable annually triggers the Code § 1272 original issue discount (OID) rules. See text accompanying fns. 4547-4552 in part Split-Dollar Loans under Reg. § 1.7872-15.

[4498] See text accompanying fns. 4561-4562 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4499] Notice 2002-8 discusses the extent to which changes in the IRS' view might affect arrangements then in effect:

> **VI. Effect On Other Documents**
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> 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.
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> 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).

constitute a material modification under Code § 101(j) (employer-owned life insurance)[4500] or 264(f) (limiting deductions for interest expense allocable to unborrowed policy cash value).[4501]

Notice 2002-59 explains the standards for valuing current life insurance protection under a split-dollar life insurance arrangement. Section 2, "Background," explains (highlighting added):

> .01. Rev. Rul. 64-328, 1964-2 C.B. 11, held that the table of one-year premium rates set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, commonly referred to as the "P.S. 58" rates, may be used to determine the value of the current life insurance protection provided to an employee under a split-dollar life insurance arrangement. Rev. Rul. 66-110, 1966-1 C.B. 12, amplified Rev. Rul. 64-328 in this respect by holding that the insurer's published premium rates for one-year term insurance may be used to measure the value of the current life insurance protection if those rates are available to all standard risks and are lower than the P.S. 58 rates. Rev. Rul. 67-154, 1967-1 C.B. 11, modified Rev. Rul. 66-110 by holding that an insurer's published term rates must be available for initial issue insurance (as distinguished from rates for dividend options) in order to be substituted for the P.S. 58 rates set forth in Rev. Rul. 55-747.
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> .02. Notice 2001-10, 2001-1 C.B. 459, revoked Rev. Rul. 55-747 and provided that, for taxable years beginning after December 31, 2001, the Treasury Department and the Internal Revenue Service would no longer treat or accept the P.S. 58 rates set forth therein as a proper measure of the value of current life insurance protection for Federal tax purposes. One concern expressed in Notice 2001-10 with regard to the P.S. 58 rates was that certain taxpayers were using P.S. 58 rates to understate the economic benefits provided under certain split-dollar life insurance arrangements, a practice never authorized by published guidance.
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> Notice 2001-10 set forth a new table of one-year term premiums, captioned as Table 2001, to determine the value of current life insurance protection on a single life provided under a split-dollar life insurance arrangement for taxable years ending after January 29, 2001. Under Notice 2001-10, Table 2001 is to serve as an "interim substitute" for the P.S. 58 rates. Notice 2001-10 also allowed taxpayers to continue to determine the value of current life insurance protection by using the insurer's lower published premium rates that are available to all standard risks for initial issue one-year term insurance as set forth in Rev. Rul. 66-110, subject to additional limitations provided in that notice.
>
> .03. Notice 2002-8, 2002-4 I.R.B. 398, revokes Notice 2001-10 and provides that, pending the consideration of comments and publication of further guidance, Rev. Rul. 55-747 remains revoked, as provided in and with the transitional relief described in Part IV.B.1 of Notice 2001-10. For split-dollar life insurance arrangements entered into before the effective date of future guidance, Notice 2002-8 allows taxpayers to use the premium rates in Table 2001 to determine the value of current life insurance protection on a single life. Notice 2002-8 also provides that taxpayers should make appropriate adjustments to the Table 2001 rates if the life insurance protection covers more than one life. For arrangements entered into before the effective date of

[4500] 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).
[4501] Notice 2008-42.

future guidance, Notice 2002-8 provides that, to the extent provided by Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154, taxpayers may continue to determine the value of current life insurance protection by using the insurer's lower published premium rates that are available to all standard risks for initial issue one-year term insurance, subject to certain express limitations. Thus, until the publication of further guidance and subject to the narrow exception in Part III.1 of Notice 2002-8, taxpayers may value the current life insurance protection by using either the premium rates in Table 2001 or the insurer's published premium rates (as described in the preceding sentence), provided that those published premium rates are lower than the rates set forth in Table 2001 (hereinafter the "insurer's lower published premium rates").

.04. On July 9, 2002, Treasury and the Service published proposed regulations relating to split-dollar life insurance arrangements (67 Fed. Reg. 45414). The proposed regulations reserve on the valuation of economic benefits received under an equity split-dollar life insurance arrangement under the economic benefit regime. However, for an equity split-dollar life insurance arrangement entered into on or before the date of publication of final regulations, in order for the parties to rely on the proposed regulations, the value of all economic benefits taken into account by the parties under the economic benefit regime must exceed the value of the current life insurance protection (determined using the life insurance premium factor designated in guidance published in the Internal Revenue Bulletin), thereby reflecting the fact that such an arrangement provides the non-owner with economic benefits that are more valuable than current life insurance protection.

The proposed regulations provide no new guidance on the valuation of current life insurance protection. In a footnote quoted immediately below, however, the preamble of those proposed regulations indicates that Part III.1 of Notice 2002-8 provides for only limited availability of the P.S. 58 rates for taxable years beginning after December 31, 2001:

> Notice 2002-8 also provides that an employer and employee may continue to use the P.S. 58 rates set forth in Rev. Rul. 55-747 (1955-2 C.B. 228), which was revoked by Notice 2001-10, only with respect to split-dollar life insurance arrangements entered into before January 28, 2002, in which a contractual arrangement between the employer and employee provides that the P.S. 58 rates will be used to determine the value of the current life insurance protection provided to the employee (or to the employee and one or more additional persons). Taxpayers may not use the P.S. 58 rates for "reverse" split-dollar life insurance arrangements or for split-dollar life insurance arrangements outside of the compensatory context.

Notice 2002-59, Section 3, "Valuation Of Current Life Insurance Protection," delineates between "reverse split-dollar" and similar arrangements in Section 3.01 and more traditional split-dollar in Section 3.02. Section 3.01 explains:

> Treasury and the Service understand that, under certain split-dollar life insurance arrangements (some of which are referred to as "reverse" split-dollar), one party holding a right to current life insurance protection uses inappropriately high current term insurance rates, prepayment of premiums, or other techniques to confer policy benefits other than current life insurance protection on another party. The use of such techniques

> by any party to understate the value of these other policy benefits distorts the income, employment, or gift tax consequences of the arrangement and does not conform to, and is not permitted by, any published guidance.

Notice 2002-59, Section 3.02 provides:

> A party participating in a split-dollar life insurance arrangement may use the premium rates in Table 2001 or the insurer's lower published premium rates only for the purpose of valuing current life insurance protection for Federal tax purposes when, and to the extent, such protection is conferred as an economic benefit by one party on another party, determined without regard to consideration or premiums paid by such other party. (See, for example, benefits described in Rev. Rul. 64-328 (in the compensatory context), Rev. Rul. 78-420, 1978-2 C.B. 67 (in the gift context), and Rev. Rul. 79-50, 1979-1 C.B. 138 (in the corporation-shareholder context).) Thus, if one party has any right to current life insurance protection, neither the premium rates in Table 2001 nor the insurer's lower published premium rates may be relied upon to value such party's current life insurance protection for the purpose of establishing the value of any policy benefits to which another party may be entitled.
>
> For example, if a donor pays the premiums on a life insurance policy that is part of a split-dollar life insurance arrangement between the donor and a trust and, under the arrangement, the trust has the right to current life insurance protection, the current life insurance protection has been conferred as an economic benefit by the donor on the trust, and the donor is permitted to value such current life insurance protection for Federal tax purposes using either the premium rates in Table 2001 or the insurer's lower published premium rates. In contrast, if a donor pays the premiums on a life insurance policy that is part of a split-dollar life insurance arrangement between the donor and a trust, and the donor (or the donor's estate) has the right to current life insurance protection under the policy, neither the premium rates in Table 2001 nor the insurer's lower published premium rates may be relied upon to value the donor's current life insurance protection for the purpose of establishing the value of the policy benefits conferred upon the trust for Federal tax purposes. Similar results obtain if the trust pays for all or a portion of its share of the policy benefits provided under the split-dollar life insurance arrangement.

Steve Akers' summary (early March 2024), "Reverse Split Dollar Life Insurance, *Cinader v. Commissioner*, Tax Court Docket No. 13491-22 to 13496-22 & 5245-22," explains what he verbally described as the taxpayer capitulating:

> a. Traditional split dollar arrangement – the insured donor pays premiums on life insurance policies owned by a trust. At the insured's death, the insured receives back certain amounts, but the trust receives the balance of the death proceeds. Table 2001 rates may be used for valuing the pure insurance coverage.
>
> b. Reverse split dollar arrangement – an irrevocable trust owns the policy and the insured pays for the right to designate who receives the death proceeds. In *Cinader*, the insured used the Table 2001 rates to determine the amount paid annually (with a note) to be able to designate the beneficiary in that year (even though, as discussed below, an IRS Notice says the Table 2001 rates cannot be used in the reverse split dollar situation).

c. Basic facts – An irrevocable trust owned a life insurance policy on the insured's life. The insured agreed to pay the trust (with notes) for the right to designate the beneficiary (of death proceeds minus the greater of the cash surrender value or the premiums paid). The Table 2001 rates were used to determine each year's repayment amount. The insured owed the trust $41,168,849 at his death, which amount was deducted for estate tax purposes.

d. The IRS's position is that Table 2001 rates cannot be used to value the pure insurance coverage when the insured does not own the policy. Notice 2002-59. (Table 2001 rates often exceed actual premium amounts.) In *Cinader*, the IRS maintained that the insured made gifts to the trust each year when using the Table 2001 rates to determine the payment amount, that the insured's debts (the notes) to the trust were not bona fide indebtedness, and therefore were not deductible for estate tax purposes under § 2053.

e. A stipulated decision was entered January 3, 2024, reporting agreed gift tax deficiencies of $3,327,230f or 2002, $99,213 for 2023, $1,424,814 for 2012, $8,433,707 for 2013, $1,527,836 for 2015 (total gift tax efficiencies of $14,813,800) and an estate tax deficiency of $14,298,629.

The economic benefit regime might also trigger the harsh nonqualified deferred compensation rules of Code § 409A.[4502] Although the Code § 409A risk described in fn. 4502 is much smaller under Reg. § 1.61-22 than under prior law, be careful to consider it in either case.[4503]

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. 4499 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-

[4502] See text accompanying fns. 4353-4354.
[4503] Reg. § 1.409A-1(b)(1) provides:

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

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

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. 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[4504] 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 giving only pure term protection to the "non-owner" and all other right to the actual or deemed "owner."

[4504] See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

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.[4505]

Reg. § 1.61-22(b)(2)(ii) provides that the following constitutes a split-dollar compensatory arrangement:

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

As to Reg. § 1.61-22(b)(2)(ii)(A), *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

[4505] Reg. § 1.61-22(b)(2)(i).

> 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.

As to Reg. § 1.61-22(b)(2)(ii)(C)(1), *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth:

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

As to Reg. § 1.61-22(b)(2)(ii)(C)(1), *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.

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.[4506]

The following constitutes a split-dollar shareholder arrangement:[4507]

(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-

[4506] *De Los Santos v. Commissioner*, T.C. Memo. 2018-155.
[4507] 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.

McGowan v. U.S., 132 A.F.T.R.2d 2023-5955 (N.D. OH 9/25/2023),[4508] held that an employer-funded life insurance arrangement was split dollar. First, it discussed Reg. § 1.61-22(b)(2)(ii):

> Plaintiffs do not dispute that the arrangement was "entered into in connection with the performance of services." Additionally, the Restricted Property Trust was a whole life insurance policy, not a group-term life insurance plan. The requirement of subparagraph A is therefore satisfied. Plaintiffs concede that the premiums were paid by the Company (the employer), which satisfies subparagraph B. And according to the terms of the Benefits Trust Agreement, upon Dr. McGowan's death, the death benefit would be paid by the RPT subtrust to Dr. McGowan's designee. His designee was his wife, Michelle McGowan. The parties primarily disagree over whether this case meets the overarching criteria that the transaction was between an owner and non-owner of the policy, which would require the Company to be treated as the policy owner.
>
> **Policy Ownership**
>
> The insurance policy was owned during the five-year Restricted Property Trust term by the DBT subtrust, which was owned by trustee Aligned Partners Trust Company. Plaintiffs contend this means the split-dollar regulation is inapplicable. Defendant responds that "in the case of a compensatory split-dollar arrangement, the employer is treated as the owner if the owner is an employee trust or welfare benefit fund."

The court quoted from Reg. § 1.61-22(c)(1)(iii), "Attribution rules for compensatory arrangements," which provides:

> For purposes of this section, if a split-dollar life insurance arrangement is entered into in connection with the performance of services, the employer or service recipient is treated as the owner of the life insurance contract if the owner (within the meaning of paragraph (c)(1)(i) of this section) of the life insurance contract under the split-dollar life insurance arrangement is -
>
> (A) A trust described in section 402(b);
>
> (B) A trust that is treated as owned (within the meaning of sections 671 through 677) by the employer or the service recipient;
>
> (C) A welfare benefit fund within the meaning of section 419(e)(1); or
>
> (D) A member of the employer or service recipient's controlled group (within the meaning of section 414(b)) or a trade or business that is under common control with the employer or service recipient (within the meaning of section 414(c)).

[4508] In discussing this case, court citations to locations of evidence are omitted from all of my quotations.

The court continued:

> Section 419(e)(1) defines a welfare benefit fund as any fund "which is part of a plan of an employer, and...through which the employer provides welfare benefits to employees or their beneficiaries." 26 U.S.C. §§ 419(e)(1). The DBT was devised for the purpose of providing benefits from the Company to Dr. McGowan. ("through this Trust Agreement, ...[the] Corporation desires to provide certain financial benefits to each employee designated on Schedule A as an incentive to remain with the Corporation and as compensation for prior valuable services rendered"). Additionally, Plaintiffs admit the DBT is a welfare benefit fund. The tax courts have previously held a corporate employer is the owner of a life insurance policy owned by a fund or trust under the split-dollar regulation. See *Our Country Home Enters., Inc. v. Comm'r of Internal Revenue*, 145 T.C. 1, 40 (2015). This Court finds that the Company is correctly treated as the owner of the policy under the regulation.
>
> Because the transaction meets the requirements of the split-dollar regulation, the taxation rules of the regulation are applicable.

When asked to reconsider its decision, 133 A.F.T.R.2d 2024-XXXX (3/13/2024), the court held its ground (citations to internal court documents omitted):

> In their Motion for Reconsideration, Plaintiffs state they take issue only with … holding … that the Company owned the insurance policy. A change in this holding, of course, would essentially undo the rest of the Court's Order, as the split-dollar regulation applies to arrangements "between an owner and a non-owner of a life insurance contract" where several other requirements are met. 26 C.F.R. § 1.61-22(b)(2)(ii). Plaintiffs argue it was incorrect to hold the Company owned the policy, as such a holding would "render[] the attribution rules [of the split-dollar regulation] applicable", the result of which "is that [the Company], which is not an 'owner' of the policy, is 'treated as the owner'[,] thereby resulting in the split-dollar regulations arguably being applicable."
>
> This was precisely this Court's previous holding: the Company is properly treated as an owner of the policy under the tax regulations, making the split-dollar regulation applicable to the transaction. As the Court previously stated, the split-dollar regulation itself treats the employer as the owner of the life insurance contract if the named owner of the contract is, among other options, a welfare benefit fund "within the meaning of section 419(e)(1)." 26 C.F.R. § 1.61-22(c)(1)(iii). Section 419(e)(1) defines a welfare benefit fund as any fund "which is part of a plan of an employer, and ... through which the employer provides welfare benefits to employees or their beneficiaries." 26 U.S.C. § 419(e)(1). The fund at issue was created expressly to provide benefits from the Company to Dr. McGowan. Plaintiffs admitted the fund was a welfare benefit fund. Plaintiffs now argue this Court incorrectly relied upon *Our Country Home Enters., Inc. v. Comm'r*, 145 T.C. 1 (2015), in which the parties stipulated that the corporate employer owned the policy. But even without this case, the definitions included in the split-dollar regulation and Section 419(e)(1) straightforwardly apply to the life insurance policy in the instant case. Plaintiffs' insistence that the company "was never a title owner of the policy" is unavailing….
>
> The Court notes it is not only the split-dollar regulation which makes the contributions to the policy non-deductible: another Treasury regulation requires that "[t]he 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 ... is treated as a distribution of property" and that "[a] payment by a corporation on behalf of a shareholder of premiums on a life insurance contract or an undivided interest therein that is owned by the shareholder constitutes a distribution of property, even if such payment is not part of a split-dollar life insurance arrangement". 26 C.F.R. § 1.301-1(m)(1) and (2). And distributions of property to shareholders are not deductible. 26 U.S.C. § 311(a). Even if the split-dollar regulation did not apply, the Company's payment of the premiums for Dr. McGowan's life insurance policy would be considered by another Treasury regulation and a statutory provision to be non-deductible distributions of property. *See also Machacek v. Comm'r*, 906 F.3d 429, 434 (6th Cir. 2018). The Court therefore finds the split-dollar regulation to be a permissible construction of the tax code under *Chevron*.

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).[4509] Generally, the split-dollar economic benefit regime[4510] applies to any arrangement that is not subject to the split-dollar loan regime.[4511] 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.[4512]

[4509] 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.

[4510] The regulatory framework for the split-dollar economic benefit regime is valid. *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015).

[4511] Reg. § 1.61-22(b)(3)(i).

[4512] Reg. § 1.61-22(c)(1)(i), which further provides:

However:[4513]

(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.[4514]

Rev. Rul. 81-198 involved the following facts:

> The donor, D, is an employee of X, a corporation. In 1974, D and X entered into a "split-dollar" arrangement to purchase a whole life insurance policy on the life of D.
>
> Under the arrangement, X pays that portion of the annual premium that is equal to the amount of the increase in the cash surrender value of the policy during the year. D pays the balance.
>
> Upon D's death, X will be entitled to receive out of the proceeds of the policy an amount equal to the funds it provided for premium payments. D has the right to name the beneficiary of the balance of the insurance proceeds.

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

[4513] Reg. § 1.61-22(c)(1)(ii)(A).
[4514] Especially fns. 4584-4586.

> X was designated as owner of the policy. However, X could not cancel, surrender or assign the policy without D's approval. Neither X nor D had an obligation to continue making premium payments.
>
> On April 1, 1981, D executed a trust agreement for the benefit of D's child, assigning all of D's rights in the policy to the trustee. However, D was to continue to pay the portion of the premium allocated to D. At that time, the total of premiums previously paid by X was $8,590. The interpolated terminal reserve and proportionate part of the last premium paid before the date of the assignment which covers the period extending beyond the date totaled $12,583.

Rev. Rul. 81-198 held:

> Since the policy had been in force for some time and further premium payments were to be made after the date of the gift, the value of the transferred interest, for purposes of section 2512 of the Code, is $3,993, the interpolated terminal reserve plus the proportionate part of the gross premium paid before the date of the gift, $12,583, reduced by the amount of funds provided by X for premiums, which is the corporation's interest in the policy, $8,590. Regarding the gift tax consequences with respect to the payment of annual premiums on the policy after the transfer. D's annual premium payment is a transfer by D for purposes of section 2511 of the Code. See section 25.2511-1(h)(3) of the regulations. Further, the value of the life insurance protection provided by the corporation, which is included in the income of D, is deemed to be transferred by D for purposes of section 2511 of the Code. See Rev. Rul. 78-420, 1978-2 C.B. 67.

The preamble to the split-dollar regulations, T.D. 9092 (9/11/2003), commented:

> The gift tax consequences of the transfer of an interest in a life insurance contract to a third party will continue to be determined under established gift tax principles notwithstanding who is treated as the owner of the life insurance contract under the final regulations. See, for example, Rev. Rul. 81-198 (1981-2 C.B. 188). Similarly, for estate tax purposes, regardless of who is treated as the owner of a life insurance contract under the final regulations, the inclusion of the policy proceeds in a decedent's gross estate will continue to be determined under section 2042. Thus, the policy proceeds will be included in the decedent's gross estate under section 2042(1) if receivable by the decedent's executor, or under section 2042(2) if the policy proceeds are receivable by a beneficiary other than the decedent's estate and the decedent possessed any incidents of ownership with respect to the policy. One commentator requested that these regulations address the extent to which a decedent's interest in a co-owned policy is included in that decedent's gross estate under section 2042, but the IRS and Treasury believe that issue is beyond the scope of these regulations and may be addressed in future guidance.

For purposes of measuring current life insurance protection, Reg. § 1.61-22(d)(3)(i) provides:

> the amount of the current life insurance protection provided to the non-owner for a taxable year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the excess of the death benefit of the life insurance contract (including paid-up additions thereto) over the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the

> owner) under the split-dollar life insurance arrangement, less the portion of the policy cash value actually taken into account under paragraph (d)(1) of this section or paid for by the non-owner under paragraph (d)(1) of this section for the current taxable year or any prior taxable year.

Reg. § 1.61-22(d)(1) provides:

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

Letter Ruling 200910002 involved the following facts:

> Settlor A and Settlor B who are married, created an irrevocable trust (Trust) on Date. Trustees were named as trustees of the trust. Under the terms of Trust, the trustee is required to distribute trust income annually to a class of beneficiaries consisting of the Settlors' living issue (but excluding their children). Each member of the class has a noncumulative power to withdraw their share of any contributions to the trust. The trustee also has the discretion to distribute corpus to a member of the class to provide for the beneficiary's health, education, support, and maintenance. If a member of the class dies survived by issue, the surviving issue become members of the class. Trust will terminate on the later of the death of the last surviving Settlor, or when the number of class members equals 40. In no event may any trust established under the Trust instrument extend beyond the applicable rule against perpetuities. Upon termination, the corpus will be divided into as many equal shares as there are then living children of the Settlors and deceased children of the Settlors who have left issue then surviving.
>
> Each share created on account of a living or deceased child of the Settlors shall be further divided into as many equal shares as there are then living children of the said child and deceased grandchildren who have left issue then surviving. Each share created for a grandchild that is age 35 at termination will be distributed outright. If a grandchild is not age 35, then the share will continue in trust for the grandchild. If a deceased grandchild is survived by issue, then the grandchild's share is to be distributed outright, per stirpes.
>
> The terms of the Trust specifically preclude either Settlor from acting as trustee. Further, the Settlors have retained no powers or authority over the Trust, Trust property, or the administration of the Trust.

> The Trust has purchased a second-to-die life insurance policy on the lives of Settlor A and Settlor B and proposes to entered into a split-dollar life insurance agreement (Agreement) with Settlors. Under the agreement, the Trust will continue to own the policy and will pay during the joint lives of the Settlors an amount equal to the insurance company's current published premium rate for annually renewable term insurance generally available for standard risks. After the death of the first Settlor, the Trust will pay an amount equal to the lesser of: (1) the applicable amount provided in § Notice 2001-10, 2001-1 C.B. 549, or subsequent IRS guidance; or (2) the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. The Settlors will pay the balance of the premiums.
>
> Under the Agreement, the Trust will collaterally assign the following rights to the Settlors: (1) if the Agreement terminates on the death of the survivor of Settlor A and Settlor B, then upon the death of the survivor, the right of the survivor's estate to receive the greater of the cash surrender value of the policy or the cumulative premiums paid by the Settlors; and (2) if the Agreement terminates during the lifetime of Settlor A and Settlor B, or the lifetime of the survivor, then within 60 days of termination, the right to receive from Trust an amount equal to the greater of the cash surrender value of the policy, or the premiums paid by Settlor A and Settlor B, to the extent Trust has other assets. Under the Agreement, all incidents of ownership over the policy (including the sole right to surrender or cancel the policy, and the sole right to borrow or withdraw against the policy) are vested in the Trustees of Trust.

Letter Ruling 200910002 reasoned and concluded:

> In the present case, under section 1.61-22(c)(1)(ii)(A)(2), A and B will be treated as the owners of Policy, because under the terms of the Agreement, the only economic benefit that will be provided under the split-dollar arrangement is current life insurance protection. Under the terms of the Agreement, Trust will pay the portion of the premium equal to the cost of current life insurance protection and Settlor A and B will pay the balance of the premium. Settlor A and/or B (or the estate of the survivor) will be entitled to receive an amount equal to the greater of the policy cash surrender value or premiums paid on early termination or at the death of the survivor. We conclude that the payment of the premiums by Settlors A and B, pursuant to the terms of the Agreement, will not result in a gift by Settlor A and B under § section 2511, provided that the amounts paid by the Trust for the life insurance benefit that the Trust receives under the Agreement is at least equal to the amount prescribed under § Notice 2001-10
>
> We also conclude that, if some or all of the cash surrender value is used (either directly, or indirectly through loans) to fund the Trust's obligation to pay premiums, Settlor A and B will be treated as making a gift at that time….
>
> In the present case, under Agreement and the collateral assignment, neither Settlor A nor B will hold any incidents of ownership in Policy. As noted above, all incidents of ownership in the policies, including 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 are vested in the Trustee of Trust. Accordingly, we conclude that the proceeds of the policy payable to the Trust will not be included in the gross estate of the second to die of A and B under § section 2042(2). The portion of the proceeds payable to the estate of

the survivor of A and B will be includible under § section 2042(1). See, *e.g.*, Rev. Rul. 79-129, 1979-1 C.B. 306.

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),[4515] 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.[4516]

However, in a unanimous reviewed decision, *De Los Santos v. Commissioner*, 156 T.C. No. 9 (2021), refused to accept this reversal outside the Sixth Circuit,[4517] commenting on the enactment of Code § 301(a):

> This provision, Congress explained, "has applicability only to distributions of property to shareholders in their capacity as such." S. Rept. No. 83-1622, at 231 (1954), 1954 U.S.C.C.A.N. 4621, 4868. "For example, a distribution of property to a shareholder who is a creditor of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301." *Ibid.*
>
> The regulations issued under section 301 must (and can) be interpreted to be consistent with this statutory mandate. Section 1.301-1(a) describes the statute as setting forth "the general rule for treatment of distributions … by a corporation to a shareholder with respect to its stock." Section 1.301-1(c) states that "[s]ection 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."
>
> These general rules, unambiguously stated at the outset of the section 301 regulations, necessarily apply to (and limit) the subsequent, more granular provisions. Those

[4515] The Sixth Circuit denied the Government's petition for rehearing on December 9, 2020.
[4516] 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. 255, citing Reg. § 1.1361-1(l)(2)(i)) and II.A.2.i.iii Disproportionate Distributions.
[4517] The Sixth Circuit consists of MI, OH, KY, and TN.

subsequent provisions often refer to “distributions to shareholders” or “property transferred by a corporation to a shareholder,” without explicitly saying-each and every time-that the distribution or transfer is being made to the shareholder “in his capacity as such.”[5] But there was no need for Treasury to include that verbiage in these more granular provisions because the general rules stated at the outset limit the scope of the regulations to distributions by a corporation with respect to its stock.

[5] *See, e.g.*, sec. 1.301-1(b), Income Tax Regs. (specifying time for inclusion in gross income of “[a] distribution made by a corporation to its shareholders,” without specifically stating that the distribution was made to shareholders in their capacity as such); *id*. para. (d)(3) (specifying consequences for “a distribution of property … by a foreign corporation to a shareholder,” without specifically stating that the distribution was made to the shareholder in its capacity as such); *id*. para. (f), Examples (1), (2), and (3) (specifying consequences of various distributions to stockholders, without specifically stating that the distributions were made to them in their capacity as such); *id*. para. (j) (specifying consequences where “property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange,” without specifically stating that the distribution was made to a shareholder in his capacity as such); id. para. (m) (providing that “[t]he cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property,” without specifically stating that this benefit is conferred on the shareholder in his capacity as such).

The same analysis applies to section 1.301-1(q)(1)(i), Income Tax Regs. It says that “[t]he provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement ... of economic benefits … is treated as a distribution of property.” *Ibid*. This sentence necessarily applies only to the provision of economic benefits to a shareholder “in his capacity as such,” because that is the only type of transfer to which section 301 applies. Interpreting “shareholder” to mean “shareholder in his capacity as such” - when used here and in comparable paragraphs of the regulation-is not only justified but is required by the statutory text and by the regulation’s introductory provisions.[6]

[6] The Sixth Circuit suggested that there was “no alternative interpretation that gives meaning to the inclusion of compensatory arrangements in § 1.301-1(q)(1)(i).” *Machacek*, 906 F.3d at 436. Again we respectfully disagree. The “alternative interpretation” that renders this provision consistent with the statute and the rest of the regulation is to interpret “to its shareholder,” as used in sec. 1.301-1(q)(1)(i), to mean “to its shareholder in his capacity as such.” That is the clear meaning of this phrase throughout sec. 1.301-1, Income Tax Regs. See supra note 5.

When proposing and finalizing the split-dollar regulations, Treasury made clear that the manner in which economic benefits are taxed depends on whether the arrangement is a compensatory arrangement or a shareholder arrangement. “[I]f the arrangement were in a compensatory context,” Treasury advised, “the employee … would account for the amount as compensation.” Sec. 1.61-22, Proposed Income Tax Regs., 67 Fed. Reg. 45417 (July 9, 2002). The final regulations similarly state that the manner in which economic benefits are taxed “[d]epend[s] on the relationship between the owner and the non-owner.” Sec. 1.61-22(d)(1), Income Tax Regs. Depending on the capacity in which the non-owner receives the transfer, it “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.” *Ibid*. Under the Sixth Circuit’s approach in *Machacek*, economic benefits received by a shareholder would invariably constitute a distribution under section 301, regardless of the relationship that accounts for the payment. We are unable to reconcile that approach either with the text of section 301(a) or with the split-dollar regulations.

Notably, the split-dollar regulations govern the taxation of such arrangements, not only for income and gift tax purposes, but also for employment tax purposes. See sec. 1.61-22(a)(1), Income Tax Regs. ("This section provides rules for the taxation of a split-dollar life insurance arrangement for purposes of … the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), … and the Self-Employment Contributions Act[.]"). It is well established that an S corporation "cannot avoid Federal employment taxes by characterizing compensation … as distributions of the corporation's net income." *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141, 145-146 (2001), *aff'd sub nom. Yeagle Drywall Co. v. Commissioner*, 54 F. App'x 100 (3d Cir. 2002).

But if a corporate employer could characterize benefits paid to employees under compensatory arrangements as section 301 "distributions," the employer could avoid paying a substantial amount of taxes that fund programs like Medicare and Social Security. An S corporation might even offer its rank-and-file employees a few shares of stock. By converting each employee into a "shareholder," the employer could avoid paying employment taxes on split-dollar insurance benefits, contrary to Treasury's evident purpose in promulgating these rules.

For these reasons, we conclude that the economic benefits received by petitioner husband under the split-dollar arrangement cannot be characterized as "distributions" under section 301. In the notice of deficiency respondent determined that these benefits, having been received under a compensatory arrangement, are taxable as "compensation for services" under section 61(a)(1) and thus as ordinary income. Although we agree that the benefits are taxable as ordinary income, we think the path to that conclusion requires a few additional steps.

Subchapter S governs the tax treatment of S corporations and their shareholders. Section 1372, one of its provisions, is captioned "Partnership Rules to Apply for Fringe Benefit Purposes." Section 1372(a) provides that, "[f]or purposes of applying the provisions of this subtitle [*viz*., subtitle A, dealing with income taxes] which relate to employee fringe benefits - (1) the S corporation shall be treated as a partnership, and (2) any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership." A "2-percent shareholder" is defined to include "any person who owns … more than 2 percent of the outstanding stock of such corporation." Sec. 1372(b).

In *Our Country Home Enterprises*, 145 T.C. at 51, we ruled that an employer's provision of economic benefits to its employees under a compensatory split-dollar arrangement "generally is deemed to be the payment of compensation." But we noted that this general rule is subject to an exception "where the employer is an S corporation that provides the benefits to a 2% shareholder in consideration for services rendered." Ibid. "In the case of such an S corporation," we reasoned, "the 2% shareholder is treated as a partner for purposes of applying the employee fringe benefit rules, the economic benefits are categorized as guaranteed payments under section 707(c), and the 2% shareholder must recognize the amount of the guaranteed payments as gross income under section 61(a)." *Ibid*.; see *Hurst v. Commissioner*, 124 T.C. 16, 35 (2005) (treating an

S corporation's payment of insurance premiums on behalf of a 2% shareholder as "guaranteed payments" under section 707(c)).

Petitioner husband owned 100% of the S Corp.'s stock at all relevant times. Under section 1372(a), the S Corp. is treated as a partnership, and he is treated as a partner, for purposes of determining the taxation of employee fringe benefits. The life insurance benefits petitioner husband received under the split-dollar arrangement are "employee fringe benefits" within the meaning of section 1372. *Our Country Home Enters., Inc.*, 145 T.C. at 51; see *Hurst*, 124 T.C. at 35. Those economic benefits are thus taxed to petitioner husband as "guaranteed payments" under section 707(c) and hence as ordinary income under section 61.

The Tax Court explained its interpretation of "fringe benefit" for the purposes of Code § 1372:[4518]

The term "fringe benefit" is commonly understood to mean "any form of employee compensation provided in addition to wages or base salary, as a pension, insurance coverage, vacation time, etc." Webster's New World Collegiate Dictionary 568 (4th ed. 2010); see Black's Law Dictionary (11th ed. 2019) (defining "fringe benefit" as a "benefit (other than direct salary or compensation) received by an employee from an employer, such as insurance"); see also Internal Revenue Manual pt. 4.23.5.15(1) (Nov. 22, 2017) (defining "fringe benefit" as a benefit "that an employee receives in addition to regular taxable wages").

Although the term "fringe benefit" is not defined in the Code, all available evidence suggests that Congress intended to adopt the common understanding of this term, *i.e.*, that a "fringe benefit" includes any employer-provided benefit that supplements an employee's salary, specifically including life insurance benefits. Because the Code "is broad enough to include in taxable income any … benefit conferred on the employee as compensation," *Commissioner v. Smith*, 324 U.S. 177, 181 (1945), any fringe benefit is taxable unless "excluded by § 132 or some other explicit exclusionary rule," Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Employee Compensation*, para. 5.1, at *1 (2020), Westlaw WGL-COMP. Section 132, captioned "Certain fringe benefits," specifically excludes from gross income eight types of fringe benefits, but split-dollar insurance benefits are not among those so excluded.

Congress codified section 1372 as part of the Subchapter S Revision Act of 1982 (Act), Pub. L. No. 97-354, 96 Stat. at 1682. In the section of the Act governing effective dates Congress provided that, in the case of "existing fringe benefits," section 1372 shall apply "only with respect to taxable years beginning after December 31, 1987." Act sec. 6(d)(1), 96 Stat. at 1699. Congress defined "existing fringe benefit" to mean "any employee fringe benefit of a type which the corporation provided to its employees as of September 28, 1982." *Id*. para. (3). By referring to "any employee fringe benefit," Congress evidently intended to give this term broad scope.

The Act's legislative history expressed Congress' understanding that "fringe benefits" within the meaning of section 1372 included various insurance benefits, such as death benefits, group term life insurance benefits, and benefits received under accident and health plans. See S. Rept. No. 97-640, at 22 (1982), 1982-2 C.B. 718, 728; H.R. Rept.

[4518] Code § 132 is referred to in the paragraph accompanying fn. 3939 in part II.P.2 C Corporation Advantage Regarding Fringe Benefits.

> No. 97-826, at 21 (1982), 1982-2 C.B. 730, 739. Both reports state, without exceptions, that "the treatment of fringe benefits of any person owning more than two percent of the stock of the corporation will be treated in the same manner as a partner in partnership." Ibid. Petitioners offer no plausible explanation why the death benefits they received under the Legacy Plan, unlike all other employer-provided insurance benefits, should be excluded from "fringe benefits" that are subject to this rule.[7]
>
> > [7] Notably, the IRS has consistently characterized split-dollar life insurance benefits as "fringe benefits" for purposes of subchapter S. See Priv. Ltr. Rul. 200441023 (Oct. 8, 2004); Priv. Ltr. Rul. 9248019 (Nov. 27, 1992). Petitioners seek to differentiate such benefits from other insurance benefits on the theory that "split-dollar arrangements represent more of a co-ownership of an asset for income tax purposes which benefits both parties." This statement is factually incorrect, at least as applied to the Legacy Plan: The Trust owned the Policy, and the S Corp. was simply deemed "the owner" for purposes of the split-dollar regulations. See sec. 1.61-22(c)(1)(ii)(A)(1), Income Tax Regs. In any event all employee benefit programs may be said to "benefit both parties." Otherwise employers presumably would not offer them to their employees.
>
> Besides pointing us to the correct technical analysis, section 1372 confirms the error of petitioners' reliance on section 1.301-1(q), Income Tax Regs. For purposes of taxing the economic benefits at issue here, section 1372 requires that the S Corp. be treated as a partnership. Although partnerships can distribute property, see secs. 731-737, they cannot make "distributions" covered by section 301, see sec. 301(a) (specifying taxability of distributions of property "made by a corporation to a shareholder"). The regulation on which petitioners rely accordingly has no application to this case. See sec. 1.301-1(q)(1)(i), Income Tax Regs. (addressing the provision of economic benefits "by a corporation to its share-holder"). Thus, even if petitioners were correct in contending that split-dollar insurance benefits received by an employee-shareholder of a C corporation would necessarily be treated as a distribution under section 301, sections 1372 and 707(c) dictate that the result is different for an employee-shareholder of an S corporation who owns 2% or more of its stock. These provisions therefore supply a distinct and independently sufficient basis for denying petitioners' motion for partial summary judgment.[8]
>
> > [8] Although the employer in *Machacek*, 906 F.3d at 430, was an S corporation, the Sixth Circuit in its opinion did not address sec. 1372, and neither party appears to have brought that provision to the court's attention.

The opinion says that the compensation is taxable as a Code § 707(c) guaranteed payment. Presumably the IRS will use the logic of Rev. Rul. 91-26 and Announcement 92-16 (both reaffirmed in Notice 2005-8) and reported on Form W-2.

In AOD 2021-02 (5/24/2021), the IRS announced its position:[4519]

> The Service's position is that these benefits must be "taken into account based on their character." *Split-Dollar Life Insurance Arrangements*, T.D. 9092, 68 Fed. Reg. 54,336, 54,339 (Sept. 17, 2003). Payments that arise from an employer-employee relationship, like those in Machacek, are compensation, not distributions subject to section 301.

[4519] See part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules, especially text accompanying and preceding fn. 272.

> Treas. Reg. § 1.301-1(q) applies only to split-dollar life insurance arrangements between a corporation and a shareholder in his or her capacity as such. See also *De Los Santos v. Commissioner*, 156 T.C. No. 9 at 16-20 (Apr. 12, 2021) (declining to follow the Sixth Circuit's reasoning and conclusion in *Machacek* in a case appealable to a different circuit).
>
> Although the Service disagrees with the decision of the court in *Machacek*, we recognize the precedential effect of the decision to cases appealable to the Sixth Circuit. Therefore, the Service will follow it in cases within that circuit if the opinion cannot be meaningfully distinguished. The Service does not, however, acquiesce in the opinion, and we will continue to litigate our position in cases in other circuits.
>
> In cases appealable to the Sixth Circuit, the Service's position is that taxpayers must adopt consistent reporting positions in light of the opinion in *Machacek*, which may result in unfavorable consequences for some taxpayers. For example, if the economic benefits of a split-dollar life insurance arrangement are treated as distributions, the costs of the arrangement will never be deductible as compensation under Treas. Reg. § 1.83-6(a)(5) or otherwise. Additionally, the Service's position is that adoption of a split-dollar life insurance arrangement by a corporation will terminate the corporation's S election (or invalidate a subsequent S election) if the arrangement provides some shareholders with superior rights to distribution proceeds. See section 1361(b)(1)(D); Treas. Reg. § 1.1361-1(*l*).

When the IRS says, "if the economic benefits of a split-dollar life insurance arrangement are treated as distributions," my best guess is that the AOD applies only if the taxpayer chooses to treat the economic benefits in that manner. However, to be safe, corporations in the Sixth Circuit should consider treating the economic benefits as distributions and giving make-up distributions to the other shareholders.

Mcgowan v. U.S., 132 A.F.T.R.2d 2023-5955 (N.D. OH 9/25/2023),[4520] in "Deductions by the Company," viewed the situation as similar to *Machacek*:

> In addition to imposing tax consequences upon Dr. McGowan, the policy's fulfillment of the split-dollar regulation requirements imposes consequences upon the Company; namely: "No premium...is deductible by the owner." 26 C.F.R. § 1.61-22(f)(2)(ii). Plaintiffs attempted to deduct the Company's premium payments as a transfer to a trust subject to substantial risk of forfeiture, pursuant to 26 U.S.C. §§ 83, and as contribution to a welfare benefit trust for an employee's benefit, pursuant to 26 U.S.C. and §§ 162 and 419. But under 26 C.F.R. § 1.301-1, economic benefits flowing from split-dollar life insurance arrangements are "treated as a distribution of property", not as the transactions under which Plaintiffs could have deducted the income. *Machacek v. Comm'r of Internal Revenue*, 906 F.3d 429, 434 (6th Cir. 2018).
>
> Despite Plaintiffs' assertions to the contrary, the facts relevant to Plaintiffs' deductions are similar to those in *Machacek*, where a company provided the premiums for its shareholder-employee's life insurance policy and deducted those premiums; the shareholder-employee included neither those premiums nor the "economic benefits flowing from the increase in value of the life insurance policy" on his tax return as individual income. *Id*. at 431. While the shareholder-employee in that case appeared to

[4520] In discussing this case, court citations to locations of evidence are omitted from all of my quotations.

argue that the tax regulations “do not carry sufficient weight to overcome Congress’ unambiguous standards expressed in [the tax code]” - as Plaintiffs here argue there is “no authority for the proposition that the IRS’s interpretive regulation, 26 C.F.R. § 1.61-22, can supersede Congressionally enacted statutes” - the regulations help determine which statutes of the tax code apply. And “[26 C.F.R. §] 1.301-1 treats economic benefits provided to a shareholder pursuant to any split-dollar arrangement as a distribution of property...and are thus deemed to have been paid to the shareholder in his capacity as a shareholder.” *Machacek*, 906 F.3d at 436. Because the policy value ought to have been included in Dr. McGowan’s income, and because the Company was not permitted to deduct the premium payments, the IRS calculations of tax liability in the Notices of Deficiency are correct, and Defendant is entitled to summary judgment on these issues.

Below are some letter rulings issued before the split-dollar regulations were promulgated:

Letter Ruling 9248019 held:

> Like the payment of accident and health insurance premiums described in Rev. Rul. 91-26, X’s payment of premiums under the split-dollar life insurance agreement is a fringe benefit to employees, not a vehicle for the circumvention of the one class of stock requirement. Therefore, based solely on the representations made and the information submitted, it is held that X’s split-dollar life insurance agreement with its employees and their spouses will not create more than one class of stock within the meaning of section 1361(b)(1)(D) of the Internal Revenue Code.

Letter Ruling 9318007 held:

> Because the arrangement provides that, at the time X pays the premiums, A, or the irrevocable trust established by A, must reimburse X to the extent the payment confers an economic benefit to that shareholder, X’s split-dollar arrangement does not alter rights to distribution and liquidation proceeds. Therefore, based solely on the representations made and the information submitted, it is held that X’s split-dollar life insurance agreement with the irrevocable trust established by A will not create more than one class of stock within the meaning of section 1361(b)(1)(D) of the Code.

Letter Ruling 9331009 held:

> Because the agreement provides that each of the shareholders or their trusts must reimburse X to the extent the payment confers an economic benefit to the shareholder, X’s split-dollar arrangement does not alter rights to distribution and liquidation proceeds. Therefore, based solely on the representations made and the information submitted, it is held that X’s split-dollar life insurance agreement with its shareholders will not create more than one class of stock within the meaning of section 1361(b)(1)(D) of the Code.

Letter Ruling 9413023 held:

> Like the payment of accident and health insurance premiums described in Rev. Rul. 91-26, X’s payment of premiums under the split-dollar life insurance agreement is a fringe benefit to B, not a vehicle for the circumvention of the one class of stock requirement. Therefore, the agreement will be disregarded in determining whether X’s shares of stock confer identical distribution and liquidation rights.

Letter Ruling 9651017 held:

> Because the arrangement provides that, at the time X pays the premiums, either (1) H, W, or the irrevocable trust established by H and W must reimburse X to the extent of the economic benefit of the life insurance protection, or (2) if H is an employee of X, X may treat the economic benefit as compensation to H during the taxable year, X's split-dollar arrangement does not alter rights to distribution and liquidation proceeds. Therefore, based solely on the representations made and the information submitted, we hold that X's split-dollar life insurance agreement with the irrevocable trust established by H and W will not create more than one class of stock within the meaning of section 1361(b)(1)(D).

Letter Ruling 9709027 held:

> Because the arrangement provides that, at the time X pays the premiums, H, through a contribution to the Trust, and payment by the Trust to X, will reimburse X to the extent of the economic benefit of the life insurance protection, the split-dollar agreement between Trust and X does not alter rights to distribution and liquidation proceeds. Therefore, based solely on the representations made and the information submitted, we hold that X's split-dollar life insurance agreement with Trust will not create more than one class of stock within the meaning of section 1361(b)(1)(D).

Letter Ruling 9735006 held:

> Because the agreements in this case provide that, at the time Company pays the premiums, the Trusts, or their settlors or beneficiaries, must reimburse Company to the extent the payments confer an economic benefit to the Trusts, Company's split-dollar life insurance agreements do not alter rights to distribution and liquidation proceeds. Therefore, based solely on the facts submitted and the representations made, we conclude that Company's split-dollar life insurance agreements will not create more than one class of stock within the meaning of section 1361(b)(1)(D).

Letter Ruling 200441023, which was issued after the split-dollar regulations, held:

> Because the agreements in this case provide that, at the time Company pays the premiums, the Recipients, must reimburse Company to the extent the payments confer an economic benefit to the Recipients, Company's split-dollar life insurance agreements do not alter rights to distribution and liquidation proceeds.

TD 9954 (9/22/2021) "adopts the 2019 proposed regulations as final regulations with no substantive changes and with certain non-substantive changes for purposes of clarity and readability," so that Reg § 1.301-1(m), "Split-dollar and other life insurance arrangements," provides:

> (1) *Split-dollar life insurance arrangements*
>
> > (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).

(2) *Other life insurance arrangements*. A payment by a corporation on behalf of a shareholder of premiums on a life insurance contract or an undivided interest therein that is owned by the shareholder constitutes a distribution of property, even if such payment is not part of a split-dollar life insurance arrangement under § 1.61-22(b).

(3) *When distribution is made*

(i) *In general*. Except as provided in paragraph (m)(3)(ii) of this section, paragraph (c) of this section applies to determine when a distribution described in paragraph (m)(1) or (2) of this section is taken into account by a shareholder.

(ii) *Exception*. Notwithstanding paragraph (c) of this section, a distribution described in paragraph (m)(1)(ii) of this section is treated as made by a corporation to its shareholder at the time that the life insurance contract, or an undivided interest therein, is transferred (within the meaning of § 1.61-22(c)(3)) to the shareholder.

(4) *Applicability date*

(i) *General rule*. This paragraph (m) applies to split-dollar and other life insurance arrangements entered into after September 17, 2003. For purposes of this paragraph (m)(4), a split-dollar life insurance arrangement is entered into as determined under § 1.61-22(j)(1)(ii).

(ii) *Modified arrangements treated as new arrangements*. If a split-dollar life insurance arrangement entered into on or before September 17, 2003, is materially modified (within the meaning of § 1.61-22(j)(2)) after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

I do not view this finalization of regulations as changing anything but included it for the sake of completeness.

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. Reg. § 1.61-22(d)(2) provides:

Value of economic benefits. The value of the economic benefits provided to a non-owner for a taxable year under the arrangement equals -

(i) The cost of current life insurance protection provided to the non-owner as determined under paragraph (d)(3) of this section;

(ii) The amount of policy cash value to which the non-owner has current access within the meaning of paragraph (d)(4)(ii) of this section (to the extent that such amount was not actually taken into account for a prior taxable year); and

(iii) The value of any economic benefits not described in paragraph (d)(2)(i) or (ii) of this section provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

McGowan v. U.S., 132 A.F.T.R.2d 2023-5955 (N.D. OH 9/25/2023),[4521] applied that regulation in its discussion, "Current Access to Cash Value":

> The Benefits Trust Agreement states Dr. McGowan had no "interest or right in or to" the policy while it was owned by the DBT, as it was in 2014 and 2015. But the split-dollar regulation defines "current access" in a perhaps counterintuitive way: "a non-owner has current access to that portion of the policy cash value...[t]o which, under the arrangement, the non-owner has a current or future right; and...[t]hat currently is directly or indirectly accessible by the non-owner, *inaccessible to the owner*, or inaccessible to the owner's general creditors." 26 C.F.R. § 1.61-22(d)(4)(ii) (emphasis added).
>
> Plaintiffs argue "the cash value could not be accessed by anyone." This fact does not, however, mean that Dr. McGowan did not have "current access" to the cash value as that term is defined under the regulation. A non-owner has "current access" when he has "future right" to cash value inaccessible to the owner, and Dr. McGowan had "a `future right' to the [p]olicy cash value because [he had] the exclusive right to designate who would receive death benefits under the [p]olicy." *De Los Santos v. Comm'r of Internal Revenue*, 116 T.C.M. (CCH) 304, at *8 (2018).
>
> Plaintiffs appear to argue that because the death benefits were subject to a "substantial risk of forfeiture" (referring to the provision that if the Company stopped paying the premiums during the policy term, the cash value of the policy would be distributed to a charity of Dr. McGowan's choosing), Dr. McGowan did not have the exclusive right to designate who would receive the benefit and thus did not have "current access".[1] The regulation makes no reference to whether a non-owner's future right to the policy value may be construed as "current access" where that future right is contingent.
>
> > [1] The Court notes as an aside that Dr. McGowan designated the charity himself, just as he designated Michelle McGowan as the beneficiary in the event of his death, which in this Court's view means that even in the event of forfeiture, he had the right to designate who would receive the policy's value.
>
> Plaintiffs contend this contingency excludes the policy's cash value from the total value of economic benefits under the regulation by contrasting it to the facts of another split-dollar regulation case, where "the facts therein are clearly and significantly distinguishable": "`The Court has repeatedly held [that the regulation] does not allow an employer to deduct its payments to a purported welfare benefit plan *where the participating employees could receive the value reflected in insurance policies purchased by those plans*." (quoting *Our Country Home*, 145 T.C. at 48 (emphasis added by Plaintiffs)). The Court is not convinced that the emphasized portions are substantially different from the facts of this case. Plaintiffs seem to believe that the word "purported" means "sham" or "fictitious" (see Doc. 103, at 21); rather, it means "imputed" or "alleged". Even so, the split-dollar regulation expressly states that it applies to welfare benefit plans. 26 C.F.R. § 1.61-22(c)(1)(iii)(C). Additionally, this *is* a case where the participating employee (Dr. McGowan) could receive the value reflected in the insurance

[4521] In discussing this case, citations to locations of evidence are omitted from all of my quotations.

> policy (by declining to renew the Restricted Property Trust transaction after the five-year term, as he did).
>
> Defendant argues that "a contingent right is still a right", and that the split-dollar regulation makes no exception for a contingent right. While Plaintiffs argue that such a contingency being "[n]oticeably absent from the Treasury Regulation" implies that it makes the regulation inapplicable, this Court finds that the regulation's plain language, including the absence of an exception for any "substantial forfeiture" provision in a policy, indicates that the regulation includes such contingent rights. Additionally, this Court notes that no insurance policy's benefit is conferred if its premiums are not paid; if potential cancellation of an insurance policy due to failure to pay premiums were enough to negate a future right to the policy's value or benefits, there is likely no case in which paragraph (d)(2)(ii) would apply. *Cf. United States v. Henry*, 983 F.3d 214, 218 (6th Cir. 2020) ("When interpreting a statute, we begin with the plain meaning of the statutory language. This requires that we look at the specific statutory language as well as the language and design of the statute as a whole.").
>
> The Court therefore finds that Dr. McGowan had "current access" to the policy cash value as defined by the split-dollar regulation, and it should have been included as part of the value of economic benefits provided to Dr. McGowan and taxed accordingly. 26 C.F.R. § 1.61-22(d)(2).

Policy cash value excludes surrender charges or other similar charges or reductions and includes policy cash value attributable to paid-up additions.[4522] 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.[4523] Note that the policy's being

[4522] Reg. § 1.61-22(d)(4)(i).

[4523] 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

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.[4524] Thus, as *McGowan* points out, the

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.

[4524] See fns. 4584-4586, in which the cash value seemed to be as inaccessible to the donor as it could possibly be, and the court dismissed out-of-hand arguments about inaccessibility because the non-owner had no current or future right to any part of the cash value. The split-dollar agreement provided:

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

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

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

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

owner needs to have the right to designate a beneficiary with respect to the death benefit consisting of at least the cash value; if not, the non-owner is treated as having received the cash value.

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

For death benefits (noting that Code § 101(a) exempts death benefits from income taxation except to the extent that the transfer for value or rules apply, if at all, or to the extent that the policy's issuance violates the employer-owned life insurance rules):[4525]

(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:[4526]

> 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-

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> 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.

[4525] 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.

[4526] Reg. § 1.61-22(e)(1).

> 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],[4527] 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).[4528]

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,[4529] then any modification that causes the employer or donor not to be treated as the donor for income tax purposes has the following consequences:[4530]

> (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

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[4527] The actual text refers to Code § 301.

[4528] 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).

[4529] Reg. § 1.61-22(c)(1)(ii)(A), reproduced in the text accompanying fn. 4513.

[4530] Reg. § 1.61-22(c)(1)(ii)(B).

undivided interest in the contract.[4531] After a transfer of an entire life insurance contract,[4532] the transferee generally becomes the owner for Federal income, employment, and gift tax purposes, including for purposes of Reg. § 1.61-22.[4533]

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

1. <u>If the non-owner buys the policy</u> (outside of an employment setting – see footnote):[4534]

   - 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:[4535]

     - 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)[4536] actually taken into account by the buyer (and the seller for gift tax and employment tax purposes), plus certain consideration[4537] 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.[4538]

   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

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[4531] Reg. § 1.61-22(c)(3).

[4532] 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.

[4533] 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.

[4534] 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.

[4535] Reg. § 1.61-22(g)(1).

[4536] Referring to benefits described in Reg. § 1.61-22(d)(2)(ii) and (iii), which are reproduced in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4537] Referring to consideration described in Reg. § 1.61-22(d)(1), which is reproduced in the text following fn. 4514 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4538] Referring to accounting for benefits under Reg. § 1.61-22(e)(3)(ii) or (g)(1)(ii).

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.[4539] 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.[4540]

- 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.[4541] Furthermore, the buyer's investment in the contract[4542] treats as premiums paid the greater of the fair market value of the contract or certain amounts accounted for under the split-dollar

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[4539] See part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured.
[4540] See fn. 4452 in part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.
[4541] Reg. § 1.61-22(g)(4)(i), which applies to a transfer of an entire policy, referring to Reg. §§ 1.61-22(b) and 1.61-2(d)(2)(ii)(A), and continues:

> After the transfer of an undivided interest in a life insurance contract (or, if later, at the time such transfer is taxable under section 83), the person who previously had been the non-owner is treated as the owner of a separate contract consisting of that interest for all purposes, including for purposes of paragraph (b) of this section and for purposes of § 1.61-2(d)(2)(ii)(A).

[4542] 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.

rules.[4543] Generally, the buyer does not get credit toward "investment in the contract" for the economic benefit of any term portion previously taken into account.[4544]

[4543] 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.

[4544] Reg. § 1.61-22(g)(4)(ii), "No investment in the contract for current life insurance protection," provides:

Except as provided in paragraph (g)(4)(ii)(B) of this section, no amount allocable to current life insurance protection provided to the transferee (the cost of which was paid by the transferee or the value of which was provided to the transferee) is treated as consideration paid to acquire the contract under section 72(g)(1) to determine the aggregate premiums paid by the transferee for purposes of determining the transferee's investment in the contract under section 72(e) after the transfer.

The above preceded the 2017 enactment of Code § 1016(a)(1)(B), which is described in the text accompanying fn. 4448 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.

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).[4545]

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. 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

[4545] 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).

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.[4546]

Reg. § 1.7872-15(a)(2) provides:[4547]

[4546] Reg. § 1.7872-15(b), referring to Reg. § 1.61-22(b) and (c).
[4547] 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.

(i) *General rule*. A payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if—

(A) The payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);

(B) The payment is a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and

(C) The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

(ii) *Payments that are only partially repayable*. For purposes of § 1.61-22 and this section, if a non-owner makes a payment pursuant to a split-dollar life insurance arrangement and the non-owner is entitled to repayment of some but not all of the payment, the payment is treated as two payments: one that is repayable and one that is not. Thus, paragraph (a)(2)(i) of this section refers to the repayable payment.

(iii) *Treatment of payments that are not split-dollar loans*. See § 1.61-22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans.

(iv) *Examples*. The provisions of this paragraph (a)(2) are illustrated by the following examples:

Example (1). Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement, the employer makes premium payments on this policy, there is a reasonable expectation that the payments will be repaid, and the repayments are secured by the policy. Under paragraph (a)(2)(i) of this section, each premium payment is a loan for Federal tax purposes.

Example (2).

(i) Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement and the employer makes premium payments on this policy. The employer is entitled to be repaid 80 percent of each premium payment, and the repayments are secured by the policy. Under paragraph (a)(2)(ii) of this section, the taxation of 20 percent of each premium payment is governed by § 1.61-22(b)(5). If there is a reasonable expectation that the remaining 80 percent of a payment will be repaid in full, then, under paragraph (a)(2)(i) of this section, the 80 percent is a loan for Federal tax purposes.

(ii) If less than 80 percent of a premium payment is reasonably expected to be repaid, then this paragraph (a)(2) does not cause any of the payment to be a loan for Federal tax purposes. If the payment is not a loan under general

> principles of Federal tax law, the taxation of the entire premium payment is governed by § 1.61-22(b)(5).

Reg. § 1.7872-15(a)(1) provides:

> If a split-dollar loan is not a below-market loan, then, except as provided in this section, the loan is governed by the general rules for debt instruments (including the rules for original issue discount (OID) under sections 1271 through 1275 and the regulations thereunder). If a split-dollar loan is a below-market loan, then, except as provided in this section, the loan is governed by section 7872. The timing, amount, and characterization of the imputed transfers between the lender and borrower of a below-market split-dollar loan depend upon the relationship between the parties and upon whether the loan is a demand loan or a term loan. For additional rules relating to the treatment of split-dollar life insurance arrangements, see § 1.61-22.

The OID rules referred to above provide that, if adequate stated interest is not paid annually, payments will be deemed made from the borrower to the lender each year, generating interest income[4548] and generally nondeductible interest,[4549] even though no cash changes hands.[4550] If 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.[4551] 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.

[4548] Code § 1272.

[4549] 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).

[4550] Reg. § 1.7872-15(f), "Treatment of stated interest and OID for split-dollar loans," provides:

> (1) *In general*. If a split-dollar loan provides for stated interest or OID, the loan is subject to this paragraph (f), regardless of whether the split-dollar loan has sufficient interest. Except as otherwise provided in this section, split-dollar loans are subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans. For example, the lender of a split-dollar loan that provides for stated interest must account for any qualified stated interest (as defined in § 1.1273-1(c)) under its regular method of accounting (for example, an accrual method or the cash receipts and disbursements method). See § 1.446-2 to determine the amount of qualified stated interest that accrues during an accrual period. In addition, the lender must account under § 1.1272-1 for any OID on a split-dollar loan. However, § 1.1272-1(c) does not apply to any split-dollar loan. See paragraph (h) of this section for a subsequent waiver, cancellation, or forgiveness of stated interest on a split-dollar loan.
>
> (2) *Term, payment schedule, and yield*. The term of a split-dollar term loan determined under paragraph (e)(4)(iii) of this section (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

[4551] 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.

Generally, a split-dollar loan will bear and <u>accrue</u> interest at the long-term applicable federal rate, so that making the loan does not constitute a gift in a donor-donee setting or compensation in an employer-employee setting. This accrued interest can be ignored for two reasons (in addition to possibly being ignored under general tax principals. First, Reg. § 1.7872-15(a)(4), "Certain interest provisions disregarded," provides:

(i) *In general*. If a split-dollar loan provides for the payment of interest and all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender), then the requirement to pay the interest (or portion thereof) is disregarded for purposes of this section. All of the facts and circumstances determine whether a payment to be made by the lender (or a person related to the lender) is sufficiently independent from the split-dollar loan for the payment to not be an indirect payment of the interest (or a portion thereof) by the lender (or a person related to the lender).

(ii) *Examples*. The provisions of this paragraph (a)(4) are illustrated by the following examples:

Example (1).

(i) On January 1, 2009, Employee B issues a split-dollar term loan to Employer Y. The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. On January 1, 2009, B and Y also enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to B in an amount equal to the accrued but unpaid interest due at the maturity of the split-dollar term loan.

(ii) Under paragraph (a)(4)(i) of this section, B's requirement to pay interest on the split-dollar term loan is disregarded for purposes of this section, and the split-dollar term loan is treated as a loan that does not provide for interest for purposes of this section.

Example (2).

(i) On January 1, 2004, Employee B and Employer Y enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to B equal to B's salary in the three years preceding the retirement of B. On January 1, 2009, B and Y enter into a split-dollar life insurance arrangement and, under the arrangement, B issues a split-dollar term loan to Y on that date . The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. Over the period in which the non-qualified deferred compensation arrangement is effective, the terms and conditions of B's non-qualified deferred compensation arrangement do not change in a way that indicates that the payment of the non-qualified deferred compensation is related to B's 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.[4552]

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,[4553] 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.[4554]

Reg. § 1.7872-15(j) controls over the usual rules governing contingent payments in making loans at the applicable federal rate (AFR).[4555] The lender puts together a projected payment schedule, which everyone directly or indirectly involved in the loan must use.[4556] 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;[4557] if the

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[4552] See text accompanying fns. 4578-4579 in part II.Q.4.f.iv.(b) Loan Regime After Initial Owner Has Died.

[4553] Reg. § 1.7872-15(a)(2)(i)(B), quoted in full in the text accompanying fn. 4547.

[4554] 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.

[4555] Reg. § 1.7872-15(j)(1) provides:

> (1) *In general*. Except as provided in paragraph (j)(2) of this section, this paragraph (j) provides rules for a split-dollar loan that provides for one or more contingent payments. This paragraph (j), rather than § 1.1275-4, applies to split-dollar loans that provide for one or more contingent payments.

[4556] 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.

[4557] 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

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.[4558] 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).[4559] Treating a nonrecourse payment as contingent may cause that payment to assigned a zero value,[4560] 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.[4561] Unless the IRS provides otherwise, "both the borrower and the lender must sign the representation not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first split-dollar loan under the split-dollar life insurance arrangement."[4562] 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."[4563]

> 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.

[4558] 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.

[4559] Reg. § 1.7872-15(j)(2)(ii).

[4560] 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.

[4561] Reg. § 1.7872-15(d)(2)(i).

[4562] 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 Rulings 200923002, 201041006, and 202336013 granted an extension of time to make the election.

[4563] Reg, § 1.7872-15(h)(1)(iv).

Once we have figured out the payment schedule that the IRS will respect, Reg. § 1.7872-15(k) applies a payment made by the borrower on all direct and indirect split-dollar loans in the following order:

(1) A payment of interest to the extent of accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued;

(2) A payment of principal on the outstanding split-dollar loans in the order in which the loans were made;

(3) A payment of amounts previously paid by a non-owner pursuant to a split-dollar life insurance arrangement that were not reasonably expected to be repaid by the owner; and

(4) Any other payment with respect to a split-dollar life insurance arrangement, other than a payment taken into account under ... (1), (2), and (3) ….

Reg. § 1.7872-15(m) describes what happens when the insurance company pays the lender:

> *Repayments received by a lender*. Any amount received by a lender under a life insurance contract that is part of a split-dollar life insurance arrangement is treated as though the amount had been paid to the borrower and then paid by the borrower to the lender. Any amount treated as received by the borrower under this paragraph (m) is subject to other provisions of the Internal Revenue Code as applicable (for example, sections 72 and 101(a)). The lender must take the amount into account as a payment received with respect to a split-dollar loan, in accordance with paragraph (k) of this section. No amount received by a lender with respect to a split-dollar loan is treated as an amount received by reason of the death of the insured.

II.Q.4.f.iv. Income Taxation of Split-Dollar Agreement After Premium Payor Dies When Life Insurance Not on the Owner’s Life

When the premium payor dies holding a split-dollar receivable on the payor’s life, the receivable is repaid immediately and correspondingly has a basis equal to the amount of the receivable, generating no income taxation.

However, if the split-dollar receivable is not on the premium payor’s life, the receivable would be valued based on when the receivable is collected. The split-dollar arrangement’s long-term nature may cause the receivable to be valued at significantly less than its face amount, leading to a step-down in basis; see the cases in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

The rest of this discussion, from part II.Q.4.f.iv, assumes that the initial owner has died and refers to the successor owner as the owner.

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.[4564] The payment's nature depends on the relationship between the owner and non-owner.[4565] 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.[4566] An advantage of just cashing out the policy with the insurance company is that the investment in the contract, which would generally exceed the stepped-down basis on the date of the original owner's death, would reduce income relative to the gain on sale, which the IRS would assert (not necessarily successfully)[4567] 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).[4568]

- 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.[4569]

4564 Reg. § 1.61-22(d)(1), quoted in the text following fn. 4514 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

4565 The part of § 1.61-22(d)(1) that follows fn. 4514 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).

4566 See fns. 4526 and 4534-4540 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

4567 See fn. 4465 in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy).

4568 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.

4569 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

- Generally, any death benefit not described above is taxable.[4570]

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,[4571] which means that any distribution from a trust or estate should be pick-and-choose fractional instead of pecuniary.[4572]

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.[4573] 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.[4574]

- To the extent of any accrued interest, the payment would have that character.[4575]

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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.

[4570] 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.

[4571] See part II.Q.4.b Transfer for Value Rule; Basis.

[4572] See part II.J.8.d Distribution in Kind; Specific Bequests.

[4573] See part II.Q.4.f.i Split-Dollar Generally, especially the text accompanying fns. 4497-4498.

[4574] 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.

[4575] See Reg. § 1.7872-15(k), reproduced in full near the end of part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15, provides that accrued interest is deemed paid first.

- To the extent that a payment is principal and the payment exceeds basis, the payment would probably be taxed as capital gain to the original holder of the note or to a substituted basis transferee or ordinary income for any other holder.[4576] 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.[4577] However, consider *Morrissette*, in which the split-dollar receivable's owner bequeathed the receivable to the split-dollar obligor.[4578] If the arrangement had been a split-dollar loan, that bequest might have violated Reg. § 1.7872-15(a)(4) (especially Example (1)), causing the interest expected to be paid under the loan to be disregarded, eviscerating most of the loan's value for gift tax purposes.[4579]

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.[4580] 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.[4581]

II.Q.4.f.v. Estate Tax Consequences of Split-Dollar Agreements

Rev. Rul. 79-129 involved the following facts:

> In 1973, D obtained an ordinary life insurance policy on D's life. The policy had a face amount of $150,000. Simultaneously, D created an irrevocable funded insurance trust and named the X Trust Company as trustee.
>
> The insurance policy designated the trustee of the insurance trust as owner of the policy. Under the terms of the policy, D possessed the right to borrow against the cash surrender value in an amount not to exceed the total amount of the policy premiums paid by D. However, the policy had no cash surrender value during the first year.
>
> The policy designated D's estate as the beneficiary of the policy proceeds to the extent of an amount equal to the cash surrender value of the policy immediately prior to D's death, less any outstanding indebtedness against the policy. The policy designated the

[4576] See fns. 2190-2191 (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.
[4577] See fn. 4524 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.
[4578] See fns. 4584-4587 in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.
[4579] Reg. § 1.7872-15(a)(4) is reproduced in full in text preceding the sentence that includes fn. 4552 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.
[4580] See text accompanying fns. 4566-4567 in part II.Q.4.f.iv.(a) Economic Benefit Model After Initial Owner Has Died.
[4581] See fn. 4525 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

> X Trust Company, as trustee of the insurance trust, as the beneficiary of the balance of the proceeds.
>
> With the exception of D’s right to borrow against the cash surrender value, noted above, all other contract rights with respect to the policy were exercisable by the trustee of the insurance trust, as owner of the policy. These contract rights included the right to assign and surrender the policy, to elect paid up insurance, and to change the beneficiary of the policy proceeds to the extent they exceeded the cash surrender value, which was payable to D’s estate.
>
> The terms of the trust provide that on D’s death, the trustee is to hold the insurance proceeds for the benefit of D’s spouse and children. The trust agreement further provides that D would be responsible for payment of the portion of the annual premium that is equal to the increase in the cash surrender value of the policy during the year. The trustee would be responsible for the payment of the balance of the annual premium.
>
> D died in 1977, more than three years after D obtained the insurance policy and created the insurance trust. Between 1973 and 1977, D paid a total of $12,000 in premiums on the policy, in accordance with D’s obligations under the terms of the trust agreement. During the period, D did not exercise the power to borrow against the cash surrender value. At the time of D’s death, the cash surrender value of the policy was $12,000. Consequently, $12,000 of the policy proceeds was paid to D’s estate. The balance of the proceeds, $138,000, was paid to the X Trust Company in accordance with the terms of the policy.
>
> On the Federal estate tax return filed for D’s estate, the executor included the $12,000 in policy proceeds payable to the decedent’s estate under section 2042(1) of the Code. The executor excluded the $138,000 balance of the proceeds, which was payable to a beneficiary other than the decedent’s estate, on the ground that this portion of the proceeds was not includible under section 2042(2) of the Code, because the incidents of ownership in the policy possessed by D could not be exercised to affect this portion of the policy proceeds.

Rev. Rul. 79-129 held that $12K of proceeds were includible in the decedent’s estate and the balance was not, based on the following reasoning:

> Section 20.2042-1(c)(2) of the Estate Tax Regulations describes “incidents of ownership” as follows:
>
>> For purposes of this paragraph, the term “incidents of ownership” is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. ....”
>
> The right of an insured to obtain a loan against the surrender value of the policy is specified in the regulations as an incident of ownership. The courts have recognized that this power furnishes grounds for including the entire policy proceeds in the gross estate, even in situations where the decedent’s power to borrow is limited to the amount of the

policy premiums. *Estate of Neuberger v. Hickey*, Civil No. 836 (N.D. N.Y. August 13, 1942); *Estate of McCoy v. Commissioner*, T.C. Memo. 1961-40.

In the situation presented in the instant case, $12,000 in policy proceeds were paid to D's estate, under the terms of the policy. Since this $12,000 in proceeds is payable to D's estate, this amount is includible in D's gross estate pursuant to section 2042(1) of the Code.

The balance of the proceeds, $138,000, was paid to the X Trust Company, a beneficiary other than the decedent's estate. Consequently, the estate taxation of these proceeds is governed by section 2042(2) of the Code.

Under the terms of the insurance contract, D possessed the right to borrow against the cash surrender value of the policy to the extent of the premiums paid by D and not recovered. In accordance with section 20.2042-1(c)(2) of the regulations, and the courts' decisions in *Neuberger* and *McCoy*, cited above, this power qualifies as an incident of ownership for purposes of section 2042(2), even though the amount D could borrow against the surrender value was limited. If the decedent possessed an incident of ownership in the policy, then the entire policy proceeds payable to a beneficiary other than the decedent's estate are includible in the decedent's gross estate regardless of the fact that a portion of the proceeds subject to inclusion could not be affected by the exercise of the incident of ownership.

Letter Ruling 9745019 involved the following facts:

You represent that the taxpayers, husband and wife, reside in a community property state. The taxpayers have three children: child A, child B, and child C. The taxpayers created an irrevocable trust in October 1996. Child A was named trustee. The terms of the trust specifically preclude the taxpayers from acting as trustees. The trust is irrevocable and the taxpayers have retained no powers or authority over either the trust or the trust property or the administration thereof.

The trust instrument provides that, during the lifetime of the taxpayers, the net income of the trust is to be paid in equal shares quarter-annually to child A, child B, and child C. Upon the death of the last to die of the taxpayers, the trust is to be divided into as many shares as there are children of the taxpayers then living and children of the taxpayers then deceased leaving issue then living (except no share is to be established for the issue of child B). Each share is to comprise a separate subtrust. The net income of each subtrust is to be paid quarter-annually for the benefit of the child for whom the subtrust was created. The principal of each subtrust may be distributed, at the discretion of the trustee, for the respective child's health, education, maintenance, or support. At the death of either child A or child C with both taxpayers deceased, the trustee of the subtrust for such deceased child is to distribute the remaining corpus of the subtrust to the issue of the deceased child by right of representation. Upon the death of child B with both taxpayers deceased, the remaining corpus of the subtrust for child B is to be distributed to the taxpayers' issue by right of representation except that no distributions are to be made to the issue of child B.

The taxpayers initially funded the primary trust with a cash gift. With this initial contribution the trustee purchased, and paid the first premium on, a second-to-die life insurance policy covering the lives of the taxpayers. The irrevocable trust was named the owner and beneficiary of the policy. The taxpayers and the trustee propose to enter into a collateral assignment split-dollar agreement with respect to any policies held by the trust.

Under the collateral assignment split-dollar agreement, the trustee is designated the owner of the policy. During the joint lives of the taxpayers, the trustee will pay that portion of the annual policy premiums equal to the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. After the death of the first taxpayer to die, the trustee will pay that portion of the annual policy premiums equal to the lesser of 1) the applicable amount provided in the P.S. 58 tables set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, or 2) the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. The taxpayers will pay the remaining portion of the annual premium. The entire premium may be remitted by the taxpayers, and, if the taxpayers remit the total premium, the trustee is obligated to reimburse the taxpayers within 30 days for the trustee's portion of the premium.

The split-dollar agreement may be terminated at will by either the trustee or the taxpayers if the value of the assets held by the trust, excluding the value of the insurance policy, but including the loan value of the policy, equal or exceed the amount that is to be paid to the taxpayers upon termination as set forth below. In all other cases, the split-dollar agreement may be terminated only through the mutual consent of the trustee and the taxpayers. The agreement will also terminate upon the bankruptcy of the taxpayers, the failure of the trustee to timely reimburse the taxpayers, the failure of the taxpayers to pay the premiums, or the death of the survivor of the taxpayers.

If the agreement is terminated prior to the death of the survivor of the taxpayers, the survivor of the taxpayers will be entitled to receive an amount equal to the cash surrender value of the policy (net of the cash surrender value at the end of the initial policy year). For a 60-day period after the date of termination the owner has the option of obtaining a release from the collateral assignment by returning to the insureds (taxpayers) or the survivor an amount equal to the then cash surrender value of the policy less the cash surrender value at the end of the initial policy year. If the owner fails to exercise this option, the insureds or the survivor have the right to surrender the policy and obtain the cash surrender value less the cash surrender value at the end of the initial policy year.

If the agreement is terminated as a result of the death of the survivor of the taxpayers, the estate of the survivor of the taxpayers (or its designated beneficiaries) will be entitled to receive an amount equal to the cash surrender value of the policy immediately prior to the death of the survivor of the taxpayers less the cash surrender value at the end of the initial policy year.

In order to secure the taxpayers' interest (or the interest of the estate of the survivor) in the policy, the trustee will assign to the taxpayers, under a collateral assignment agreement, certain rights in the policy. Under the agreement, the following rights are assigned to the taxpayers: 1) the right to receive a portion of the proceeds payable on the survivor's death equal to the taxpayers' interest under the split-dollar agreement; and 2) the right to receive the cash value of the policy if the policy is surrendered by the trustee, less the cash surrender value amount at the end of the initial policy year. All

> other rights with respect to the policy are reserved to the trustee and all such rights may be exercised solely by the trustee subject to the taxpayer's security interest.

Letter Ruling 9745019 summarized Code § 2042(2) and Reg. § 20.2042-1(c)(2)[4582] and then reasoned and ruled:

> In the present case, the taxpayers have retained no incidents of ownership in the second-to-die life insurance policy on their lives. In the event that the trust includes assets (other than the insurance policy) such that these assets when added to the loan value of the policy would allow the trustee to pay the specified amount upon termination and the taxpayer(s) elects to cancel the agreement, the trustee could pay the taxpayer(s) an amount equal to the cash surrender value of the policy (net of the cash surrender value at the end of the initial policy year). The taxpayer(s) cannot, thus, force the cancellation of the policy.
>
> We conclude that the insurance proceeds payable to the trust pursuant to the split-dollar agreement from the second-to-die life insurance policy held by the irrevocable trust will not be includible in the gross estate of the last taxpayer to die under section 2042.

Letter Ruling 9809032 involved the following facts:

> On May 7, 1982, Decedent created an irrevocable trust (Trust) and transferred certain life insurance policies to the trust. Individual and Corporation were appointed trustees of the Trust and continue to serve as trustees.
>
> Paragraph C of Article FIRST of Trust provides that the trustees are vested with all right, title, and interest in and to the policies of insurance that were transferred to the trust and any additional policies of insurance assigned to the trust by any person. Paragraph C also authorizes the trustees to exercise all options, benefits, rights, elections, privileges, and other powers under the policies, including the right to borrow upon the policy or policies, to pledge any for a loan, to surrender any policy for the cash surrender value, and to convert a policy into other forms of insurance.
>
> Paragraph E of Article FIRST authorizes the trustees to receive all payments on insurance policies.
>
> Paragraph (4) of Article SECOND provides that, at the death of Decedent and if his wife predeceases him, the trustees shall pay $1,000,000 to Individual, if he survives decedent or, if not, to Individual's issue that survive Decedent. If the $1,000,000 amount is more than five percent of the Decedent's gross estate including the principal held by the Trustees, the amount shall be reduced so that it is no greater than five percent of Decedent's gross estate. The balance of the remaining principal shall be paid to the issue of the Decedent.
>
> Article THIRD provides that Trust's principal shall be divided into equal shares, one for each of Decedent's children who is then living and each of his children who has died leaving issue.

[4582] Reg. § 20.2042-1(c)(2) is reproduced in part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

> Article THIRTEENTH provides that, during Decedent's life, the trustees shall receive compensation for their services as fiduciaries as is determined by Decedent. Individual is granted the authority to name a successor trustee provided any such successor trustee is a partner of Individual's law firm.
>
> Decedent died on October 27, 1996, survived by his three children, A, B, and C. During Decedent's life, the trustees borrowed from the Decedent amounts that were documented with promissory notes. The amounts borrowed were used to pay premiums on the insurance policies and, at his death, five of the notes were outstanding. The terms of the notes are substantially identical except for the amount borrowed and the interest rate prevailing at the time each note was executed. The executor has represented that the Decedent owned and controlled the notes through a revocable trust and that the notes are includible in Decedent's gross estate for federal estate tax purposes.

Letter Ruling 9809032 ruled:

> In this case, Decedent transferred insurance policies to Trust during his life. Trust was irrevocable and authorized the trustees to exercise all options, benefits, rights, elections, privileges, and other powers under the policies, including the right to borrow upon the policy or policies, to pledge any for a loan, to surrender any policy for the cash surrender value, and to convert a policy into other forms of insurance. The trustees were Individual and Corporation. Under these circumstances, Decedent did not have the incidents of ownership in the policies as that term is defined in section 20.2042-1(c)(2).
>
> In addition, the trustees borrowed from Decedent amounts that were used to pay premiums on the insurance policies. At Decedent's death, five of the notes were outstanding. Under section 2042, the payment of premiums is irrelevant in determining whether a decedent retained any incidents of ownership in the policy proceeds. *Estate of Leder v. Commissioner of Internal Revenue*, 893 F.2d 237 (10 Cir. 1989); *Estate of Headrick v. Commissioner of Internal Revenue*, 918 F.2d 1263 (6th Cir. 1990).
>
> Accordingly, based on the facts submitted and the representations made, we rule … the decedent did not possess any incidents of ownership in the policy under section 2042(2) as a result of loaning the amounts for payments of life insurance premiums to the trust.

The split-dollar economic benefit regime regulations do not apply for estate tax purposes.[4583]

Apparently taking advantage of this gap, *Estate of Morrissette v. Commissioner*[4584] held that a taxpayer's entering into a heavily discounted generational split-dollar agreement[4585] did not

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[4583] See fn. 4509 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4584] 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*.

[4585] 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 constitute a gift, even though the decedent bequeathed her interest to the other party in the split-dollar arrangement.[4586] In that case, the mother funded life insurance owned by irrevocable life insurance trusts ("ILITs") to fund cross purchase buy-sell obligations that her children had to each other. Because the mother had to wait until her children died to receive cash on the split-dollar receivables and the ILITs had full control over the policies, the mother's estate tax return reported that her right to receive the almost $30 million she invested was worth only approximately $7.5 million. Because the split-dollar receivable would have a low basis, repayment would have generated significant income tax; by bequeathing the receivable to the

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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.

[4586] The IRS apparently argued that bequeathing the decedent's split-dollar interest to the other party to the contract made the restrictions illusory. From the opinion:

> Respondent argues that the Dynasty Trusts had a direct or indirect right in the cash values of the insurance policies by virtue of the terms of the 2006 Amendment to the CMM Trust. Under that amendment, the CMM Trust's interest in the cash values of the policies would pass to the Dynasty Trusts or directly to Mrs. Morrissette's sons or their heirs upon her death. However, because the CMM Trust was a revocable trust with respect to Mrs. Morrissette, she retained an absolute right to alter the CMM Trust throughout her lifetime. Accordingly, the Dynasty Trusts did not have a legally enforceable right to the cash values of the policies during the lifetime of the grantor. Furthermore, the split-dollar life insurance arrangements did not require the CMM Trust to distribute the receivables to the Dynasty Trusts. Rather, Mrs. Morrissette retained the right to receipt of the receivables.

The decedent's ability to amend her revocable trust was pure legal fiction, which legal fiction this case takes to the extreme. From the finding of facts:

> [The decedent's sons] Arthur, Donald, and Kenneth petitioned the Circuit Court of Fairfax County, Virginia (Fairfax court) for appointment of a conservator for Mrs. Morrissette's estate and asked the conservator to transfer additional assets to the CMM Trust. On August 18, 2006, the court found Mrs. Morrissette to be permanently incapacitated and appointed Cathleen A. Hatfield, an employee of the Interstate Group, to serve as the conservator. The Fairfax court granted Ms. Hatfield broad authority to act on Mrs. Morrissette's behalf. The conservatorship expired on October 20, 2006.

The conservator did the following during that 2-month period:

1. Established Dynasty Trusts,
2. Amended the revocable trust to authorize entering into the split-dollar agreements and bequeathing the revocable trust's interest in each split-dollar agreement to the other party to the split-dollar agreement, and
3. Entered into a buy-sell agreement requiring the life insurance.

Then, the Dynasty Trusts bought the policies and, together with the revocable trust (of which the sons were co-trustees), entered into the split-dollar agreements.

The idea that this arrangement would ever be modified was ludicrous, given that the sons orchestrated this entire transaction for their benefit, using as the conservator an employee of the company that they directly or beneficially owned, to set up a multi-million dollar transaction in a compressed period of time.

The following facts might have helped the estate's case:

- The purchase of the policies was for a legitimate and significant nontax reason [my assumption that the *Bongard* test might have been in the court's mind - see fn. 91 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.

other party the agreement, the mother might have prevented that result.[4587] However, in a similar situation, *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, held that Code §§ 2036, 2038, and 2703[4588] may very well apply, probably not qualifying for the exception for a sale for adequate and full consideration that would prevent the former two[4589] from applying because the split dollar receivable was only a small fraction of the amount of money the decedent contributed to the agreement.[4590] The court failed to address Reg. § 20.2038-

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[4587] 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. 7175, found in part III.B.5.b Promissory Notes. However, if *Morrissette* had used the loan regime, bequeathing the note may have caused the loan to be disregarded for gift tax purposes, which would have made the whole amount advanced constitute a gift. See fn. 4552 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4588] The court held:

> On the basis of the undisputed facts, we conclude that under section 2703(a)(1) the split-dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value. The estate claims that decedent paid $10 million to the insurance companies for the benefit of MB Trust and in return received certain rights, namely, the termination rights (which the estate claims are worthless) and decedent's death benefit rights (which, according to the estate's valuation theory, are worth less than 2% of the cash surrender value). MB Trust, meanwhile, paid nothing into this arrangement and received MB Trust's death benefit rights. As best we understand the estate's valuation theory, MB Trust's death benefit rights are allegedly worth at least the cash surrender value minus the value of decedent's death benefit rights (*i.e.*, $9,611,624 – (allegedly) $183,700 = $9,427,924). Nothing in the parties' filings suggests that MB Trust ever paid, or was obligated to pay, any interest or other amount to compensate decedent for MB Trust's acquisition and use of this amount….
>
> Next, it is clear that under section 2703(a)(2) the split-dollar agreements, and specifically MB Trust's ability to prevent termination, also significantly restrict decedent's right to use the termination rights. The split-dollar agreements, taken as a whole, clearly restrict decedent's right to terminate the agreements and withdraw his investment from these arrangements.

[4589] 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).

[4590] 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.

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."[4591] 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*.[4592] On February 19, 2019, the court

[4591] 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)."

[4592] The court reasoned and ruled (Docket No. 4415-14):

> Petitioners argue that the decedent's only right under the split-dollar arrangements was the death benefit and that right was without restriction. They argue that the property being valued is the death benefit, the death benefit is free of any restriction as defined in section 2703(a)(2), and accordingly section 2703(a) does not apply to the valuation of the split-dollar arrangements. They argue that the split-dollar arrangements did not contain any restrictions on the decedent's rights for purposes of section 2703(a)(2). They state, without further analysis, that the termination restriction, *i.e.*, that neither party had the unilateral right to terminate the split-dollar arrangements, is not a restriction for purposes of section 2703(a)(2).
>
> Respondent argues that the decedent's rights also include the termination right and receipt of a payout upon termination. He argues that the termination right were restricted by the split-dollar arrangements and that section 2703(a)(2) applies to disregard the termination restrictions. He also argues the decedent had rights under collateral assignment agreements. He contends that the CMM Trust and the Dynasty Trusts entered into agreements in which the Dynasty Trusts assigned the insurance policies to the CMM Trust as collateral for its $30 million premium prepayment, and the collateral assignments contained a restriction that should be disregarded under section 2703(a)(2). He argues that neither the termination restriction nor the collateral assignment restriction is inherent or necessary to a split-dollar agreement. See *Estate of Strangi v. Commissioner*, 115 T.C. 478, 488-489 (2000), *aff'd* in part, *rev'd* on another issue, 293 F.3d 279 (5th Cir. 2002) (holding that section 2703 did not apply to disregard partnership entity to cause partnership assets to be included in the estate); *cf. Estate of Elkins v. Commissioner*, 140 T.C. 86 (2013), *aff'd* in part, *rev'd* in part, 767 F.3d 443 (5th Cir. 2014) (applying section 2703(a) to disregard restriction on decedent's right to institute a partition action for undivided fractional interests in art work); *Holman v. Commissioner*, 130 T.C. 170 (2008) (applying section 2703 to disregard restrictions in partnership agreement on partner's right to transfer her partnership interest). He argues that we should deny summary judgment in petitioners' favor because genuine issues of material fact exist. He argues that the Court should find that section 2703 applies to the decedent's rights under the split-dollar arrangements as a matter of law, but he did not file a cross-motion for summary judgment on this issue. If section 2703 applies, respondent argues that we should disregard the termination restrictions pursuant to section 2703 and value the decedent's rights under the split-dollar arrangement as if she had the right to unilaterally terminate the agreements. He does not seek to disregard the split dollar arrangements in their entirety.
>
> 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

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." Ultimately, however, T.C. Memo 2021-60 held that Code § 2036 did not apply:[4593]

> Taking into account the totality of the facts and circumstances, the CMM trust had legitimate and significant nontax purposes for entering into the split-dollar agreements and funding payment of the premiums in exchange for repayment plus interest in the form of inside buildup. An important purpose of the transfer was to promote the management succession and efficiency and to protect corporate profits for the accumulation of capital to develop the business. On the basis of the record before us, we find that unrelated parties would have agreed to similar terms. Respondent has not argued otherwise….
>
> To qualify for the bona fide sale exceptions, the transfer must have been made for adequate and full consideration in money or money's worth….
>
> Compliance with the economic benefit regime does not mean that the adequate and full consideration requirement is met. *Estate of Cahill v. Commissioner*, at *33. Under the plain text of the regulations, the economic benefit regime does not apply for estate tax purposes. The regime is set out in the income tax regulations, and the regulations state that the regime applies for income, gift, employment, and self-employment tax purposes. Sec. 1.61-22(a), Income Tax Regs. Estate tax is not listed. The economic benefit regime does not use the phrase "adequate and full consideration" or otherwise invoke the concept of adequate and full consideration….
>
> We hold that the CMM trust received adequate and full consideration on the basis of the split-dollar agreements' repayment terms that included interest earned in the form of inside buildup of the insurance policies. The minimum interest rates and the actual appreciation in the policies' cash values were higher than the interest rates that the CMM trust had been earning on the money. Respondent does not argue that the repayment terms were inadequate. The split-dollar agreements also provide the additional benefit of deferral of tax on the policies' inside buildup and the tax-exempt payout of the death benefits to the beneficiaries.

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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.

[4593] These are strategic excerpts from the full analysis that is reproduced in the text following fn. 7581 in part III.C.3 Whether Code § 2036 Applies.

> Estate tax saving was not achieved through execution of the split-dollar agreements alone but rather through the undervaluation of the split-dollar rights….

The court held that Code § 2703 did not apply,[4594] which is not surprising given that it bought into the bona fide arguments for Code § 2036. However, the court did not buy into the estate's valuation, holding the split-dollar agreement would be unwound much earlier than its stated termination (thereby undermining the effect of various discounts):

> Petitioners argue that there was no prearranged plan to terminate the split-dollar agreements when the agreements were executed. We are not convinced. When the 2006 plan was implemented, the CMM trust agreement was amended to distribute the split-dollar rights to the respective dynasty trusts that owned the underlying policies. Such a distribution indicates an intent to give the dynasty trusts full control over the policies once the distribution occurred. Such control makes it appropriate to apply a maturity date, and we apply a maturity date of December 31, 2013. That is the date that respondent seeks. Accordingly, we do not apply an earlier one. We acknowledge that Ken testified that he did not intend to cancel the policies. While we find him credible, the brothers were free to choose to cancel the policies after the agreements were distributed to the dynasty trusts. From the outset, the plan was to give the dynasty trusts complete control after Mrs. Morrissette's death, and the CMM trust agreement was so amended. Respondent points to other facts to support a December 31, 2013, maturity date including the decision to purchase policies with high premiums and modest death benefits and July 2010 emails between Don, Mr. Meltzer, and Mr. McNair that discuss the possibility of canceling certain policies. Mr. McNair responded to Don that he insisted that the policies not be canceled until the three-year period of limitations on the estate return had expired. This is the basis for respondent's choosing December 31, 2013, as the maturity date. Petitioners raise valid objections to the emails including that Ken and Buddy were not involved and the discussion started out about the effect of cancellation of the policies on Mr. Meltzer's future commissions. However, on our review of all the facts and circumstances, the key factor in setting the December 31, 2013, maturity date is the brothers' complete control over the split-dollar agreements. As stated above, there are grounds for setting an earlier maturity date, but we will use respondent's date.

The court imposed an undervaluation penalty:

> When considering reliance on an appraisal as a defense to a valuation penalty, we consider the methodology and assumptions underlying the appraisal, the appraised value, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer. *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26, at *48. In this case we place the most weight on the appraised value, less than $7.5 million. Mr. Stephanson's opined value was not reasonable, and the brothers should have known that. The brothers had the CMM trust pay $30 million and turned it into $7.5 million for estate tax reporting purposes. They should have known that the claimed value was unreasonable and not supported by the facts.
>
> While the brothers credibly testified to the business and nontax purposes for entering into the split-dollar agreements, they also knew that Mr. Meltzer and Mr. McNair were marketing the agreements as an estate tax saving strategy. Mr. Meltzer and Mr. McNair made it clear that the tax benefits of the split-dollar agreements would be obtained

[4594] See text accompanying fn. 7506 in part III.B.7.e Code § 2703 Overview.

> through the undervaluation of the split-dollar agreements, and the brothers knew from the time they decided to enter into the split-dollar agreements that any estate tax saving depended on valuing the split-dollar rights at a substantial discount from the premiums that the CMM trust paid. In July 2010, before the return's filing, Mr. McNair warned Don that the IRS would likely see problems with the values of the split-dollar rights that the estate had planned to report on the return. Nevertheless, the brothers had the estate report substantially discounted values on the return.
>
> Mrs. Morrissette had significant, nontax reasons for entering into the split-dollar agreements. However, the only purpose for the substantially discounted values of the split-dollar rights as compared to the $30 million that the CMM trust paid is estate tax saving. Knowing that any estate tax saving would be from the undervaluation of the split-dollar rights, the brothers engaged an appraiser that Mr. McNair recommended. Mr. McNair reviewed a draft of Mr. Stephanson's appraisal and asked Mr. Stephanson to make changes that reduced his opined values.
>
> Mr. Stephanson's appraisal was not reasonable, and petitioners did not rely on it in good faith. Accordingly, the estate is not entitled to rely on Mr. Stephanson's appraisal as a reasonable cause defense. The estate did not act reasonably or in good faith in the valuation of the split-dollar rights. The estate is liable for the 40% penalty for the gross valuation misstatement of the split-dollar rights.

On the other hand, the taxpayer won *Estate of Levine v. Commissioner*, 158 T.C. No. 2 (2/28/2022). The Syllabus summarized the facts:

> D, the deceased, entered into split-dollar life-insurance arrangements which required her revocable trust to pay premiums for life-insurance policies taken out on the lives of her daughter and son-in-law. When the arrangements terminate, D's revocable trust has the right to be paid the greater of the premiums paid or the cash surrender value of the policies. An irrevocable life-insurance trust was the owner of these policies. D's children and grandchildren were the beneficiaries of the irrevocable trust, and F, a family friend who was substantially involved in the family's businesses, was the sole member of the investment committee that managed the irrevocable trust. F and two of D's children also acted as D's attorneys-in-fact and as the revocable trust's successor cotrustees. As the sole member of the irrevocable trust's investment committee, only F had the right to prematurely terminate the life-insurance policies: the arrangements gave D and the other two attorneys-in-fact no rights to terminate the policies or the arrangement itself.

Levine reviewed the general rules of estate inclusion when the life insurance is not on the life of the person advancing the premiums:

> On this we have precedent. In *Morrissette I*, we held that a split-dollar arrangement much like this one fell under the economic-benefit regime for gift-tax purposes. But we also noted in *Morrissette I*, 146 T.C. at 172 n.2, that "we [were] not deciding whether the estate's valuation of the receivables...in the gross estate [was] correct." And section 1.61-22(a)(1) seems not to cover the estate-tax consequences of split-dollar arrangements at all.21 The final regulations do make one reference to estate tax in their preamble, which states "[f]or estate tax purposes, regardless of who is treated as the owner of a life insurance contract under the final regulations, the inclusion of the policy proceeds in a decedent's gross estate will continue to be determined under section 2042." T.D. 9092, § 5, 2003-2 C.B. 1055, 1063. But the express terms of section

> 2042 limit its applicability to life-insurance policies on a decedent's own life, not split-dollar arrangements where policies are taken out on the lives of others. See § 2042(1); Treas. Reg. § 20.2042-1(a)(2) ("[S]ection 2042 has no application to the inclusion in the gross estate of the value of rights in an insurance policy on the life of a person other than the decedent"). From this we conclude that neither the regulation nor section 2042 governs our valuation of the split-dollar arrangement we have to analyze.

Levine rebuffed the IRS' Code §§ 2036, 2038 attacks, first comparing Code § 2036(a)(2) inclusion in *Estate of Strangi*, T.C. Memo. 2003-145, and *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), to the taxpayer's win in *United States v. Byrum*, 408 U.S. 125 (1972):

> In *Byrum*, the Supreme Court held that a decedent's right to vote shares of stock in three corporations that he had transferred to a trust for the benefit of his children did not cause those shares to be included in his estate under section 2036(a)(2). The Court noted that any powers the decedent might have had were subject to a number of different "economic and legal constraints" that prevented those powers from being equivalent to the right to designate a person to enjoy trust income. *Id*. at 144. One of these constraints was that the decedent, as the controlling shareholder of each corporation whose stock was transferred into the trust, owed fiduciary duties to minority shareholders that limited his influence over the corporations' dividend policies. *Id*. at 142-43. The Supreme Court also noted that an independent corporate trustee alone had the right under the trust agreement to pay out or withhold income, *id*. at 137, so the decedent had no way of compelling the trustee to pay out or accumulate that income, *id*. at 144. That the decedent had fiduciary duties to these minority shareholders - duties that were legally enforceable - was important to the Supreme Court's analysis. *Id.* at 141-42.
>
> We have been careful to distinguish *Byrum* in later cases when we see something behind a transaction's facade that suggests appearance doesn't match reality. *Estate of Strangi*, 85 T.C.M. (CCH) at 1333-34, featured a decedent who could act with others to dissolve a family limited partnership to which he had transferred property in exchange for a 99% limited-partner interest. The decedent in *Estate of Strangi* - through his son-in-law—also had the right to determine the amount and timing of partnership distributions. *Id*. at 1337. This led us to distinguish *Byrum*, because in *Byrum* the son-in-law had fiduciary duties to other members of the family limited partnership; in *Estate of Strangi*, the son-in-law's potential fiduciary duties - as the decedent's attorney-in-fact and 99% owner of the family limited partnership - were duties he owed "essentially to himself." *Id.* at 1343.
>
> We decided *Estate of Powell* on essentially the same grounds as *Estate of Strangi*. In *Estate of Powell*, 148 T.C. at 394-95, a fiduciary also owed duties to the decedent both as his attorney-in-fact and as partner in a family limited partnership. We found that there was nothing in the record of that case to suggest that as a fiduciary he "would have exercised his responsibility as a general partner of [the family limited partnership] in ways that would have prejudiced decedent's interests." *Id*. at 404. And we again determined that whatever duties were owed were duties that "he owed almost exclusively to decedent herself." *Id.*
>
> Here's where the Commissioner makes his thrust. He contends that Levine - through her attorneys-in-fact - stood on both sides of these transactions and therefore could unwind the split-dollar transactions at will. This meant that she - again through the attorneys-in-fact - had the power to surrender the policies at any time for their cash-surrender values.

(Remember that, under the terms of the split-dollar arrangements, if the Insurance Trust surrendered the policies before the deaths of both Nancy and her husband, it would immediately owe the Revocable Trust the full cash-surrender values of the policies.) The Commissioner argues that these powers constitute the right to possession and enjoyment of, or the right to income from, the split-dollar receivable under section 2036(a)(1). If he's right, we would have to value the receivable at the policies' cash-surrender values.

We agree that Robert, Nancy, and Larson - as Levine's attorneys-in-fact - stood in the shoes of Levine for this split-dollar arrangement. That is the point of giving someone a power of attorney. The Revocable Trust is the entity that paid the $6.5 million, and its cotrustees are Nancy, Larry, and Larson. The Insurance Trust, however, owns the life-insurance policies, and its trustee is South Dakota Trust. South Dakota Trust is directed by the investment committee, and the investment committee's only member is Larson. This, however, means that the only person that stood on both sides of the transaction is Larson -in his role as the investment committee and as one of Levine's attorneys-in-fact.

We therefore must look at each of Larson's roles in this transaction to consider how to apply sections 2036(a) and 2038. Under the 1996 power of attorney and Minnesota law, all actions taken by Larson as an attorney-in-fact are considered to be actions of Levine. See Minn. Stat. § 523.12 (2008).[25] The Insurance Trust's instrument, however, states that the Insurance Trust is irrevocable. We have no reason to doubt that this means what it says. And the consequence is that Levine irrevocably surrendered her interest in the Insurance Trust and had no right to change, modify, amend, or revoke its terms. Once it was created, Levine had no legal power over its assets. Levine did not have the power to surrender the policies by herself. Since Larson - in his role as an attorney-in-fact - could not take any action which Levine could not take herself, we find that he could not surrender the policies in his capacity as attorney-in-fact. This means that even if we treat the Insurance Trust, the policies, or that Trust's rights under the split-dollar deal as the "property transferred" (and thus the property whose value we look for) under section 2036, Levine did not retain any right to possession or enjoyment of the property transferred.

[25] The Minnesota statute states: "Any action taken by the attorney in-fact-pursuant to the power-of-attorney binds the principal, the principal's heirs and assigns, and the representative of the estate of the principal *in the same manner as though the action was taken by the principal* ...." (Emphasis added.)

To get around these problems, the Commissioner has to argue that Larson has the right to designate who shall possess or enjoy the cash-surrender value of the policies, either by surrendering them or by terminating the entire arrangement. See *Estate of Cahill*, 115 T.C.M. (CCH) at 1467. For example, in Estate of Cahill, we found that section 2036(a)(2) applied when the decedent jointly held the right to terminate the split-dollar life-insurance policy with the irrevocable trust that held the policies. *Id*. We think that's the only way the Commissioner can include the combined cash-surrender values of the life-insurance policies in Levine's estate under section 2036(a)(2) or section 2038.

But we also think that this argument fails to consider the fiduciary obligations Larson owes to the beneficiaries of the Insurance Trust—obligations that would prevent him from surrendering the policies. The Commissioner first questions the validity and existence of these duties. He notes that "Larson was not compensated for his role as the sole member of the Investment Committee despite the fact that petitioner has taken the position that he assumed significant fiduciary responsibilities under this role." But we don't think that matters. There is no requirement under either South Dakota law[26] or general trust law[27] that a trustee or trust adviser be compensated to have fiduciary obligations. The terms of the Insurance Trust expressly state that Larson—in his role as the single-member investment committee - shall be considered to be acting in a fiduciary capacity. Therefore we do find that Larson was under fiduciary obligations in his role as the sole member of the investment committee.

[26] S.D. Codified Laws § 55-1B-4 (2008) provides:

> If one or more trust advisors are given authority by terms of the governing instrument to direct, consent to, or disapprove a fiduciary's investment decisions, or proposed investment decisions, *such trust advisors shall be considered to be fiduciaries when exercising such authority unless the governing instrument provides otherwise*"

(Emphasis added).

And S.D. Codified Laws § 55-2-1 (2008) provides that "[i]n all matters connected with his trust a trustee is bound to act in the highest good faith toward his beneficiary . . . ."

[27] *Restatement (Third) of Trusts* § 70, cmt. d(1) (Am. L. Inst. 2007) states that "[w]hether or not a person receives compensation for serving as trustee, the person is subject to a duty to administer the trust in accordance with its terms . . . with prudence . . . and in good faith and conformity with other fiduciary duties referred to in Clause (b)."

Larson's duties in his role for the Insurance Trust required him, however, to look out for the interests of that Trust's beneficiaries. And here is where the Commissioner makes a different and subtler argument. He contends that, since Nancy and Robert are beneficiaries of the Insurance Trust, they stand to benefit under the split-dollar arrangement regardless of whether the life-insurance policies remain in place or are surrendered during their lifetime. This means, he says, that Larson would not violate his fiduciary duties to the beneficiaries of the Insurance Trust if he either surrendered, or didn't surrender, the policies because Nancy and Robert would benefit no matter what. If Larson immediately terminated the split-dollar arrangement, surrendered the policies, and sent the money out of the Insurance Trust to the Estate and then to Levine's children, he'd just be benefiting the children in a different capacity.

To this subtle thrust, the Estate has a blunt parry: Levine's children are not the only beneficiaries under the Insurance Trust. Her grandchildren are also beneficiaries, and Larson has fiduciary obligations to them as well. According to the terms of the Insurance Trust, Levine's grandchildren would receive nothing if the life-insurance policies were surrendered. Left unmentioned is the final step in this argument - that Larson has no right to violate his fiduciary obligations by looting the Insurance Trust for the benefit of only some of its beneficiaries.

The Commissioner counters by arguing that the Insurance Trust itself allows Nancy and Robert to extinguish their children's interests in it. This means, he says, that Nancy and Robert are the only real beneficiaries, and stand to benefit regardless of whether the life insurance policies stay in effect.

This misinterprets the way that “extinguishment” works under the provisions of the Insurance Trust, however. The Trust plainly states that “the special testamentary power of appointment hereby granted to said Beneficiary shall not be exercisable in favor of or for the benefit of the Beneficiary ...”—i.e. they can’t extinguish another beneficiary’s interest in favor of themselves. The Insurance Trust also states that extinguishment of a beneficiary’s interest can occur only by will and cannot take place until the death of the beneficiary doing the extinguishing (which in this case would be Nancy or Robert). So if Nancy and Larry hoped to extinguish the interests of their own children, they couldn’t do so until they themselves directly named some other beneficiary to take their place. This means that during the lives of Nancy and Robert, their children will remain beneficiaries of the Insurance Trust, and a decision by Larson to surrender the policies would mean the grandchildren would receive nothing. This would breach his fiduciary duties to them.

Levine’s case is thus distinguishable from *Estate of Strangi* and *Estate of Powell*. Many of the same “economic and legal constraints” that existed in *Byrum* exist here. First, the fiduciary obligations that Larson owed were not duties that he “essentially owed to himself.” His fiduciary obligations are owed to all the beneficiaries of the Insurance Trust, which include not just Levine’s children, but her grandchildren. As we’ve already discussed, if Larson surrendered the life insurance-policies, those grandchildren would receive nothing as beneficiaries. That makes these fiduciary obligations more analogous to the duties owed to the minority shareholders in *Byrum*, which like them are duties that do limit the powers of the person who holds them. They are also legally enforceable duties, established by South Dakota state law, *see, e.g.*, S.D. Codified Laws §§ 55-2-1, 55-1B-4 (2008), and if Larson breached these duties or was put in a position where he was forced to do so, he would be required under S.D. Codified Law § 55-2-6 (2008) to inform all of the beneficiaries of the Insurance Trust, and he could be removed. He could also be subject to liability under South Dakota law for breach of his duty. *See, e.g.*, *Matter of Heupel Fam. Revocable Tr.*, 914 N.W.2d 571 (S.D. 2018) (trustee breaching fiduciary duties removed and required to personally reimburse trust).

We stress that the fiduciary duties that Larson owed to the beneficiaries of the Insurance Trust do not conflict with the fiduciary duties that he owed Levine as one of her attorneys-in-fact. In both *Estate of Strangi* and *Estate of Powell* we held that the fiduciary’s role as the attorney-in-fact would potentially require him to go against his duties as a trustee. *Estate of Strangi*, 85 T.C.M. (CCH) at 1343; *Estate of Powell*, 148 T.C. at 404. This is not the case here: Under Minnesota law, whenever Larson and the other attorneys-in-fact exercise their powers, they are to do so “in the same manner as an ordinarily prudent person of discretion and intelligence would exercise in the management of the person’s own affairs and shall have the interests of the principal utmost in mind.” Minn. Stat. § 523.21 (1992). And Larson, Nancy, and Robert all credibly testified that one of the reasons for this split-dollar arrangement was that Levine wished to provide for her grandchildren and keep this arrangement in effect until the insureds died. So not only did Larson’s role as an attorney-in-fact not require him to go against his duties as a trustee, the two roles reinforced each other and pushed him to fulfill Levine’s stated purpose in her estate planning. They made it more likely that he would not want to cancel the life-insurance policies.

We therefore find it more likely than not that the fiduciary duties that limit Larson’s ability to cancel the life-insurance policies were not “illusory”. It also persuades us that we cannot characterize his ability to unload the policies and realize their cash-surrender values as a right retained by Levine, either alone or in conjunction with Larson, to designate who shall possess or enjoy the property transferred or the income from it.

We conclude that this precludes the inclusion of the cash-surrender values of the life-insurance policies in Levine's estate under section 2036(a)(2).[28]

[28] Section 2036(a) also excepts from its sweep transfers that are bona fide sales for adequate and full consideration. We need not determine whether this exception applies.

Section 2038 focuses on a decedent's power to "alter, amend, revoke, or terminate" the enjoyment of the property in question. The Commissioner's argument under section 2038 mirrors his argument under section 2036 - that the attorneys-in-fact have controlled the entirety of Levine's affairs since 1996, and that this control includes the ability to "alter, amend, revoke or terminate" any aspect of the split-dollar arrangements. He argues again that the termination of the split-dollar arrangements would provide Levine - through her attorneys-in-fact - with complete control over the cash-surrender values of the policies, and the power to do this would fall within section 2038(a)(1). He argues that it applies to section 2038(a)(1) for the same reasons that he argues it applies to section 2036. We disagree for the same reasons and need not repeat them.

The cash-surrender values of the insurance policies are not includible under section 2038(a)(1) either. The cash-surrender values of the insurance policies are not includible under section 2038(a)(1) either.[29]

[29] Section 2038 also includes an exception for a "*bonafide* sale for an adequate and full consideration in money or money's worth." We need not decide whether this exception applies here.

Levine rebuffed the IRS' Code § 2703 argument that the split-dollar agreement was a restriction on the estate's property:

We disagree. Section 2703 does refer to "any property." But the "any property" it refers to is property of an estate, not some other entity's property. Our caselaw confirms the plain meaning of the Code, and tells us to confine section 2703's valuation rule to property held by a decedent at the time of her death. *See, e.g., Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), aff'd in part, rev'd in part, 293 F.3d 279 (5th Cir. 2002). The district court in *Church v. United States*, 85 A.F.T.R.2d 2000-804 (W.D. Tex. 2000), aff'd without published opinion, 268 F.3d 1063 (5th Cir. 2001), rejected precisely this argument when it held that "property" in section 2703 consideration does not include assets that a decedent contributed to a partnership before her death, but only the partnership interest she got in exchange. *See also Estate of Strangi*, 115 T.C. at 488 ("Congress 'wanted to value property interests more accurately when they transferred, instead of including previously transferred property in the transferor's gross estate'" (citing *Kerr v. Commissioner*, 113 T.C. 449 (1999), aff'd, 292 F.3d 490 (5th Cir. 2002))).

The property we have to value here is the property in Levine's estate, which is the split-dollar receivable she held at the time of her death. There were no restrictions on that property. She could do with the receivable what she wanted. She was free to sell it or transfer it as she wished. One needs to remember that what the Estate valued on its return was the receivable owned by Levine in her Revocable Trust. Section 2703 is not

> relevant to the valuation of the receivable because Levine had unrestricted control of it. Section 2703 therefore does not apply.
>
> The only property left in the Estate after this arrangement was done was the split-dollar receivable. It is the value of that property that must be included in the gross estate, and the parties have agreed that its value is $2,282,195. The Estate having almost entirely prevailed, no accuracy-related penalties apply.

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,[4595] 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.[4596] 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

[4595] 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. 4358.

[4596] 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. Reg. § 20.2042-1(c)(6) is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy.

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.

inaccessible to the owner.[4597] 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. 4596 risks being recharacterized as being owned by the employee (and therefore the employer's premium being considered paid to the employee to the extent not attributable to the employer's retained rights to absolutely control cash value) unless the split-dollar agreement is absolutely tight about the employer being entitled to the full cash value. For those less than absolutely confident that the agreement, when using the economic benefit regime consider making the case that the entire arrangement is for the employer's business purpose – the employer receives the employer's portion of the death benefit, and the balance of the death benefit was provided through reasonable compensation for valuable services that the insured provided to the employer or through sharing the premium. However, *Morrissette*'s approval of a split-dollar policy as being solely owned by the premium payer (other than current life insurance protection) will boost the confidence of practitioners regarding the ability to draft agreements without risking the named owner being treated as the owner for income and gift tax purposes; see fn. 4584.

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. 4584); 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,[4598] name the donee as the owner.

Letter Ruling 200728015 involved the following facts:

> Taxpayers A and B, husband and wife, have four adult children. On Date 1, Taxpayers' four children each established an irrevocable trust, Trusts 1-4 (collectively "Trusts"), for the sole benefit of each child's respective descendants. Taxpayers A and B have no beneficial interest in the Trusts. An unrelated third party is the current trustee of the Trusts. In addition, each Taxpayer has renounced the right to serve as trustee of the Trusts.
>
> On Date 2, a trust created under the will of Decedent for the benefit of Taxpayer A loaned $X to each Trust. The Taxpayers represent that they have made no contributions to the Trusts and will make no contributions to the Trusts in the future.
>
> The Trusts purchased a second-to-die life insurance policy (Policy) on the lives of Taxpayers A and B. The Policy lists the Trusts as joint owners and each trust is designated as the beneficiary of 25 percent of the policy proceeds.
>
> On Date 3, Taxpayers and trustees of the Trusts formed a limited partnership under State law (Partnership). The Taxpayers each own a 1% general partnership interest and a 47% limited partnership interest. The Trusts each own a 1% limited partnership interest. On Date 4, prior to January 28, 2002, the Partnership and the Trusts entered into a collateral assignment split-dollar life insurance agreement (Agreement). Under the Agreement, during the joint lives of Taxpayers A and B, the Trusts will pay that portion of

[4597] Reg. § 1.61-22(d)(2)(ii) - see fn. 4523 for text of the relevant regulations.
[4598] See fns. 4584-4586.

> the annual premium due equal to the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. After the death of the first insured to die, the Trusts will pay the portion of the annual premium equal to the lesser of (i) the applicable amount provided in the P.S. 58 tables set forth in Rev. Rul. 55-747, 1955-2 C.B. 228 or (ii) the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. The Partnership will pay the balance of any premium amount. The Agreement further provides that upon the death of the last to die of Taxpayer A and Taxpayer B, Partnership is to be paid from the Policy proceeds an amount equal to the greater of (i) the cash surrender value of the Policy immediately prior to the death of the survivor of the last to die of Taxpayer A and Taxpayer B, or (ii) the net premiums paid by the Partnership. In the event the Agreement is terminated prior to death of the last to die of Taxpayer A and Taxpayer B, then the Partnership is entitled to receive an amount equal to the cash surrender value of the Policy.
>
> To secure the Partnership's right to repayment, the Trusts executed a collateral assignment of the Policy to the Partnership. The collateral assignment provides that the Trusts shall retain and possess all incidents of ownership, including, the sole and exclusive right to surrender or cancel the policy for its cash surrender value; the right to designate and change the beneficiary of the death benefits; the right to elect and exercise any optional mode of settlement or dividend payment permitted by the Policy; and the sole right to obtain loans secured by the Policy or make withdrawals from the Policy.
>
> It is further represented that on Date 5, a date after September 17, 2003, while Taxpayer A and Taxpayer B were alive, the Agreement was terminated. At the time Agreement was terminated, the Policy had a cash surrender value of zero. Immediately after the Agreement was terminated, as part of a negotiated agreement with the insurance company, the insurance company waived the surrender charges with respect to the Policy, and the Policy was exchanged by the life insurance company for a new policy (Policy 2), a fully paid up policy but with a significantly lower death benefit. The Trusts are listed as the joint owners of Policy 2 and each Trust is listed as the designated beneficiary of 25% of the proceeds.

As to estate tax issues, Letter Ruling 200728015 reasoned and ruled:

> Any incidents of ownership in a life insurance policy held by the partnership are effectively held by the partners as individuals. Rev. Rul. 83-147,1983-2 C.B. 158.
>
> In the instant case, Taxpayers did not retain any interests in the Trusts that would cause the corpus of the respective trusts to be included in the Taxpayers' gross estates under section 2036. Further, the Partnership held no incidents of ownership in the Policy under the terms of the Agreement, as described above. See, Rev. Rul. 79-129, 1979-1 C.B. 306. Thus, no incidents of ownership in the Policy or Policy 2 will be attributed to Taxpayers as a result of their ownership interest in the Partnership, nor would Taxpayers be treated as relinquishing any incidents of ownership in the Policy or Policy 2 for purposes of section 2035, if either Taxpayer was to die within three years of the termination of the Agreement on Date 5. No portion of Policy or Policy 2 will be includible in the gross estate of the second to die of Taxpayer A or Taxpayer B.

The collateral assignment that secured the Taxpayers' interest in Letter Ruling 200728015 gave all of the incidents of ownership to the Partnership, other than securing the Taxpayers' interest. This is referred to as a "bare bones" collateral assignment. I have been told that other "bare bones" collateral assignments were in Letter Rulings 9204041, 9511046, 9651030, 9709027, 9808024, 9848011, and 9318009.

Lee Slavutin suggests the following guidelines for drafting generational split dollar agreements:[4599]

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.[4600] An "employer-owned life insurance contract" (a term that applies to much more than one would think) does not receive the exclusion unless certain notice and consent requirements are met.[4601]

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.[4602] An "applicable policyholder" means, with respect to any employer-owned

[4599] A Post-*Morrissette* Roadmap for Drafting Intergenerational Split Dollar Agreements, *Steve Leimberg's Estate Planning Email Newsletter* - Archive Message #2414 (5/12/2016).
[4600] Code § 101(j).
[4601] Code § 101(j)(1), (2).
[4602] Code § 101(j)(3)(A).

life insurance contract, the person described in the preceding sentence who owns the contract[4603] at the time it is issued.[4604]

"Employee" includes a "highly compensated employee" under Code § 414(q),[4605] and Code § 414(q)(1)(A) pulls in people who own at least 5% of the company.[4606] Thus, an owner who is not an employee is an "employee" for purposes of this rule by being a 5% owner.[4607]

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.[4608] The only way that this requirement makes any sense is if the policy was issued to the person treated as the insured's employer under these rules - this requirement would be impossible to satisfy if it was issued to the insured or someone else because the person treated as an employer might not even know about the policy. Thus, "applicable policyholder" should mean the person to whom the policy is issued when the insured is an "employee" of that person.[4609]

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:

[4603] Code § 101(j)(3)(B)(i).

[4604] 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. 4609.

[4605] Code § 101(j)(5).

[4606] 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.

[4607] 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.

[4608] Code § 101(j)(4).

[4609] 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.

- 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.[4610]

- Another qualifying relationship is if, when the contract is issued, the insured is a director, certain highly compensated employees, or a 5% owner.[4611] (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.)[4612]

- 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.[4613]

- 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.[4614] 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.[4615] It also would guard against

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[4610] 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. 4605-4607.

[4611] Code § 101(j)(2)(A)(ii). The reference to a 5% owner is described in the text accompanying fns. 4605-4607. 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. 4606 in part II.Q.4.g.i Analysis of Code § 101(j).

[4612] See text accompanying fns. 4602-4604.

[4613] Code § 101(j)(2)(B)(i). "Family member" refers to Code § 267(b)(4).

[4614] Code § 101(j)(2)(B)(ii).

[4615] One might consider provisions such as that found in part II.Q.4.g.ii Consent Integrated into Operating Agreement. The sample is an attempt to be a catch-all in case clients do not follow the recommended procedure. Letter Ruling 201217017 approved what appears to have been a similar provision in a corporate buy-sell agreement:

> … the Agreement provides that Taxpayer will obtain life insurance on the life of each Shareholder, and that Taxpayer will be the owner and beneficiary of such life insurance. If the Agreement is terminated, or a Shareholder disposes of his interest in Taxpayer as allowed by the Agreement, a Shareholder has the right to purchase from Taxpayer any Taxpayer-owned life insurance covering his life. If the life insurance was not purchased, Taxpayer retained the right to surrender or otherwise dispose of the life insurance.

The ruling concluded:

> …considering all of Taxpayer's documentation as a whole, for the Contracts listed in the Appendix, all of the requirements of § 101(j)(4) were met before the issuance of the Contracts:
>
> a) through the Agreement and the Application, each Shareholder was notified in writing that Taxpayer intended to insure the Shareholder's life;
>
> b) through the Application, each Shareholder was notified in writing of the maximum face amount for which the Shareholder could be insured at the time the Contract was issued, in dollars;
>
> c) by signing both the Agreement and the Application, each Shareholder consented to being insured under the Contract;

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.[4616] 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.[4617] 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);[4618] step transaction concerns might suggest that the insured transfer the policy into a life insurance LLC[4619] instead of waiting long enough (whatever that means) to avoid an assertion of the step transaction doctrine.

The proposed policy owner should obtain the insured's written consent before the life insurance application is signed.

Consider having the maximum face amount in that consent provide a cushion in excess of the largest amount that the parties can conceive of that death benefit being (including increased death benefits due to investing the cash value very successfully).

An insurance agent might provide such a consent form, which counsel should consider reviewing, or counsel could provide his/her own consent form to the client. Although some agents understand these issues, many agents do not know (or think they know but actually

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.

[4616] Leimberg and Zaritsky, IRS Provides New and Substantial Guidance on Employer-Owned Life Insurance, 36 *Estate Planning*, No. 8, 3 (August 2009).

[4617] 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.

[4618] 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.

[4619] See part II.Q.4.i Life Insurance LLC.

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.[4620] "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.[4621]

These rules for life insurance contracts issued or materially changed after August 17, 2006.[4622] Notice 2009-48 elaborates on the rules described above, as well as providing rules for what constitutes a material modification,[4623] including guidance on tax-free exchanges.[4624]

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.[4625] However, if the business owns it,[4626] the following rules apply (emphasis added):[4627]

[4620] Code § 6039I(a) is the general reporting requirement, and Reg. § 1.6039I-1 specifies the form.

[4621] Code § 6039I(c).

[4622] 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. 4501-4503.

[4623] 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.

[4624] 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.

[4625] A-1.

[4626] Including through a grantor trust that the business established, per A-1.

[4627] After A-3 and before Q-4.

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 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. 4615 for authority for relying on such a provision; however, I recommend obtaining a separate notice and consent for more direct evidence to show the IRS. The rest of this part II.Q.4.g.ii is the sample:

The Company or Members may from time to time obtain life insurance policies on the lives of the Members. In the event those policies fall within the definition of "employer-owned life insurance policies" as defined in Code section 101(j), it is intended that the policies qualify for an exclusion from those rules (and thus the proceeds will be income tax-free) and that this Operating Agreement comply with the notice and consent requirements necessary to obtain that exclusion. Therefore, each Member is hereby given written notice that the Company or Members intend to insure his or her life by purchasing life insurance policy(ies) in the maximum face amount of $___________, and that the Company or Members will be the owner and beneficiary of that policy and of any proceeds payable on such Member's death. Each Member (by signing this Operating Agreement) hereby gives advance written consent to being insured under such policy(ies) and to the continuation of the policy(ies) after such Member ceases to have an Interest in the Company or otherwise terminates employment (as defined in Code section 101(j)(4)(B)) with the Company (and no inference is intended that a Member is an "employee" for any purposes other than the possible application of Code section 101(j)). The Members also agree to enter into a specific notice and consent containing these terms with regard to each policy obtained before the issuance of that policy.

II.Q.4.g.iii. Consent for Owner Who Is Not an Employee

As mentioned in part II.Q.4.g.i, a person owning at least 5% of a company is treated as an employee for purposes of this rule, even if that person not an employee. The rest of this part II.Q.4.g.iii is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _____ Owner

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ______________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______. Although the Employer does not employ me, I understand that my ownership in the Employer makes me considered an "employee" for purposes of I.R.C. Section 101(j). Therefore:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I no longer own an interest in the Employer or otherwise terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.g.iv. Consent for an Employee

The rest of this part II.Q.4.g.iv is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _______ Employee

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ____________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______, and:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.h. Establishing Estate Tax Values

For estate tax purposes, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[4628] If a decedent owns voting and nonvoting shares, the shares are valued together as a single block.[4629]

Suppose a company is worth $4M and A owns 75% of the company. Perhaps A's estate would want to be bought out for $3M, which is 75% of $4M.

Suppose the company then buys a $3M policy insuring A's life, so it could buy A's interest when A dies. On A's death, however, the company is worth $7M – the sum of its $4M normal value and $3M of life insurance. Should the company have to pay 75% of $7M for A's interest, because of this life insurance? That higher price certainly would not honor the parties' intent. If

[4628] Reg. § 20.2031-1(b). Rev. Rul. 59-60 and its progeny discuss valuation principles.
[4629] *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

the parties agree that A's estate gets $3M instead of 75% of $7M, does that mean that A has bequeathed the difference to the company's other owners? Imposing estate tax on A's estate for money that the estate will never receive is certainly an unfair result. On the other hand, if the company's other owner was A's son or some other natural object of A's bounty, then perhaps A's goal was essentially to bequeath the difference to that other owner. In the latter case, A's estate should pay estate tax on the difference and – depending on A's intent – perhaps recover the extra estate tax from that other owner.

How does the estate tax system differentiate between these situations? Regarding buy-sell agreements, Reg. § 20.2031-2(h), "Securities subject to an option or contract to purchase," provides:

> Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

Thus, a buy-sell or similar agreement must apply during a decedent's life as well as after death before it might be given effect. Recent cases have reaffirmed this requirement. *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004); *Estate of Blount*, T.C. Memo. 2004-116, *aff'd* in part, *rev'd* in part, 428 F.3d 1338 (11th Cir. 2005) (life insurance included in valuing company, but the Eleventh Circuit treated the buy-sell obligation as offsetting the inclusion); *Smith III v. U.S.*, 96 A.F.T.R.2d 2005-6549 (W.D. Pa. 2005). In a case citing *True* but taking an unusual tack, *Huber v. Commissioner*, T.C. Memo. 2006-96, the IRS tried to use a buy-sell agreement against a taxpayer, but Judge Goeke ruled that a right of first refusal in the agreement did not increase the value of the subject stock. Not mentioned in the *Huber* opinion is that, according to one of the taxpayer's counsel, prior gift tax audits had accepted the taxpayer's appraisals or settled very close to it, so the IRS' posture was radically different than before. In *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999), *aff'g* in part and *rev'g* in part T.C. Memo. 1996-286, life insurance proceeds did not increase the value of the decedent's interest in the law firm to which he had belonged, except as necessary to take into account advanced client costs and work in process pursuant to the buy-sell agreement.

If a buy-sell agreement is held to have testamentary intent rather than a legitimate business purpose, a bargain sale may constitute a gift.[4630]

[4630] See quote from *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, in the text preceding fn. 3830 in part II.O.2.c Effect of Buy-Sell Agreement on Marital Deduction.

Reg. § 20.2031-2(h) is not the only hurdle. For purposes of gift, estate and GST tax, if applicable[4631] Code § 2703(a) provides that the value of any property shall be determined without regard to:

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

Thus, when a parent transfers an equity interest to a child pursuant to a legally binding stock option or buy-sell agreement, generally for gift, estate and GST tax purposes the parent is deemed to make a taxable transfer to the extent that the equity interest's value exceeds the payment under that agreement. Reg. § 25.2703-1(a)(3) provides:

> A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

A waiver of the right to partition art was disregarded under Code § 2703(a)(2).[4632]

However, Code § 2703(b) provides that Code § 2703(a) does not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

As to the "bona fide" prong of Code § 2703(b)(1), *Holman v. Commissioner*, 130 T.C. 170 (2008) held:

> We believe that [the transfer restrictions] were designed principally to discourage dissipation by the children of the wealth that Tom and Kim had transferred to them by way of the gifts. The meaning of the term bona fide business arrangement in section 2703(b)(1) is not self-apparent. As discussed supra, in *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76, we interpreted the term bona fide business arrangement to encompass value-fixing arrangements made by a conservator seeking to exercise prudent management of his ward's minority stock investment in a bank consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate. Those are not the purposes of [the transfer restrictions]. There was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance report as justifying buy-sell agreements consistent with petitioners' goals of educating their children as to wealth

[4631] See part III.B.7.e Code § 2703 Overview, including the Reg. § 25.2703-1(b)(3) exception in the text preceding and accompanying fn. 7504.
[4632] *Elkins v. Commissioner*, 140 T.C. No. 5 (2013).

> management and disincentivizing them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares.

The court had cited this portion of the legislative history (an informal report of the Senate Committee on Finance):

> [Buy-sell agreements] are common business planning arrangements … that … generally are entered into for legitimate business reasons…. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance….

The Eighth Circuit affirmed, 601 F.3d 763 (2010):

> Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no business, active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that maintenance of family ownership and control of [a] business may be a bona fide business purpose. *St. Louis County Bank*, 674 F.2d at 1207; see also *Estate of Bischoff v. Commissioner*, 69 T.C. 32, 39-40 (1977). We have not so held, however, in the absence of a business. [footnote described below]
>
> That is not to say we necessarily believe it will always be easy to apply § 2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult. See, e.g., *Higgins v. Commissioner*, 312 U.S. 212, 217–18 (1941) (holding in another context that merely keeping records and collecting interest and dividends did not amount to carrying on a business); *Estate of Thompson v. Commissioner*, 382 F.3d 367, 380 (3d Cir. 2004) (Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations.).

In footnote 3 discussing the *St. Louis County Ban*k case, 674 F.2d 1207 (8th Cir. 1982), the court pointed out:

> In *St. Louis County Bank*, for example, the transferred interests were shares in a family company that had started out as a moving, storage, and parcel-delivery business and evolved into a real estate management company. *St. Louis Bank*, 674 F.2d at 1208–09. When engaged in the moving and storage business, the company had created a stock-purchase agreement based on a valuation formula keyed to income. *Id*. At 1209. Later, the family exited the moving and storage business but kept the business structure as a vehicle for renting real estate. *Id*. With this new activity, the formula resulted in a dramatically lower value. *Id*. We stated, We have no problem with the District Court's findings that the stock-purchase agreement provided for a reasonable price at the time of its adoption, and that the agreement had a bona fide business purpose—the maintenance of family ownership and control of the business. Courts have recognized the validity of such a purpose. *Id*. at 1210.

Judge Beam offered a strong dissent:

> Here, the Tax Court made the express factual determination that the partnership agreement restrictions were designed principally to protect family assets from dissipation by the Holman daughters. *Holman*, 130 T.C. at 195 (emphasis added). In other words, the Tax Court determined that the restrictions were designed primarily to serve a non-tax purpose. Notably, the Tax Court did not find that the Holmans merely paid lip service to legitimate business purposes for the restrictions while, in reality, using the restrictions for the primary purpose of avoiding taxes. [footnote omitted] Additionally, the Tax Court did not find that the restrictions failed to match the partnership's legitimate, non-tax goals. [footnote omitted] The underlying purposes of § 2703 are not served where, as here, the bona fide business arrangement test is applied in a manner that discourages partners in family partnerships from creating restrictions principally to achieve non-tax, economic goals. Thus, I would hold that the Holman partnership agreement restrictions are bona fide business arrangements because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners' fundamental right to choose who may become a partner.
>
> …Under § 2703(b)(3)'s comparable terms test, the Holman partnership restrictions' terms must be comparable to similar arrangements entered into by persons in an arms' length transaction. While the Tax Court did not decide whether the restrictions satisfied the comparable terms test, it noted that both parties' experts agree that transfer restrictions comparable to those found in [the *Holman* partnership agreement] are common in agreements entered into at arm's length. [footnote omitted] *Holman*, 130 T.C. at 198–99. The Tax Court explained that this would seem to be all that [the Holmans] need to show to satisfy section 2703(b)(3). *Id*. at 199. I agree, and I would hold that the *Holman* partnership restrictions satisfy § 2703(b)(3)'s comparable terms test. Thus, because the partnership restrictions satisfy all three of § 2703(b)'s tests, I would reverse and remand to the Tax Court for a valuation of the limited partnership interests that does not disregard the partnership restrictions.

The U.S. District Court for the Southern District of Indiana, following *Holman*, held that holding undeveloped land did not constitute a business that could qualify for the Code § 2703 safe harbor. *Fisher v. U.S.*, 106 A.F.T.R.2d 2010-6144. The court later ruled that the taxpayer could not introduce into evidence the discounts that the IRS had used on audit, ruling that the IRS' audit determination was irrelevant to determining the actual value.

For an in-depth discussion of the facts of some of these cases, see Aghdami, Mancini, & Zaritsky, *Structuring Buy-Sell Agreements*, ¶ 6.02[4] Restriction on Lifetime Transfer.

As to the "device" prong of Code § 2703(b)(2), Judge Beam's dissent in *Holman v. Commissioner*, 601 F.3d 763 (2010), argued that "decedent" in Code § 2703(b)(2) means it does not apply to gifts:

> Having determined that the partnership restrictions satisfy § 2703(b)(1), I now turn to § 2703(b)(2)'s device test. Under this test, the Holman partnership restrictions must not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. I.R.C. § 2703(b)(2) (emphasis added).

> Treasury Regulation § 25.2703-1(b)(1)(ii) excises the phrase members of the decedent's family found in § 2703(b)(2) and substitutes in its place the phrase natural objects of the transferor's bounty, apparently because the Secretary of the Treasury interprets § 2703(b)(2) to apply to both inter vivos transfers and transfers at death. Holman, 130 T.C. at 195–96. Applying this regulation, the Tax Court held that the Holman partnership restrictions operate as a device to transfer property to the natural objects of the Holmans' bounty. The Holmans argue that Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it fails to give effect to § 2703(b)(2)'s plain language. I agree. [discusses Chevron deference] The parties primarily dispute whether § 2703(b)(2) is ambiguous. The Holmans assert that the term decedent unambiguously refers to a deceased person and, therefore, § 2703(b)(2) asks only whether restrictions operate as a device to transfer property to family members at death. The Holmans point out that only the term decedent, not the broader term transferor, is used throughout § 2703(b)(2)'s legislative history. Conversely, the Commissioner argues that the term decedent is ambiguous due to § 2703's location in the Internal Revenue Code. Specifically, § 2703 is located in Subtitle B of the Code, which includes three transfer taxes—the estate, gift and generation-skipping transfer taxes. More precisely, § 2703 is located in Subtitle B, Chapter 14. In Chapter 14, § 2703 joins a set of special valuation rules targeting transfer tax avoidance schemes. It is clear that the phrase members of the decedent's family unambiguously limits § 2703(b)(2)'s application to transfers at death. First, the term decedent is itself unambiguous. *Black's Law Dictionary* 465 (9th ed. 2009) plainly defines decedent as [a] dead person. Moreover, the phrase members of decedent's family is not ambiguous when read in the greater context of Chapter 14. While Congress used the term decedent in § 2703(b)(2), it used the broader term transferor in Chapter 14's other valuation statutes. See I.R.C. §§ 2701(a)(1) & 2702(a)(1). And, as the Holmans point out, the term decedent consistently appears in § 2703(b)(2)'s legislative history. Finally, I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase members of the decedent's family with the Commissioner's phrase natural objects of the transferor's bounty. See *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at 6 n.3 (W.D. Pa. June 30, 2004). Thus, although Congress enacted Chapter 14 to generally address transfer tax avoidance schemes, § 2703(b)(2) applies specifically to transfers at death. Therefore, Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it does not give effect to the plain language of § 2703(b)(2). Since the Holmans are living persons, they are, by definition, not decedents and § 2703(b)(2)'s device test is satisfied.

Huffman v. Commissioner, T.C. Memo. 2024-12, commented:

> For the second requirement of section 2703(b), we consider the totality of the facts and circumstances. *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60, at *100. Whether an agreement "constitutes a testamentary device depends *in part* on the fairness of the consideration received by the transferor when it executed the transaction." Id. (emphasis added) (citing *Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff'd*, 390 F.3d 1210 (10th Cir. 2004)).

After noting that the parties agreed that Code § 2703(b)(1) was satisfied, *Huffman* continued under the heading, "Whether the RTP Agreements Were a Testamentary Device," concluding that they were not:

> We note the significant amount of earnings growth that would have had to occur for the options to become "in the money…." If we average the parties' per-share 1993 values

($0.49 per share), the Dukes shares that Chet purchased in 2007 had increased in value by 2,414%.

> We view this level of growth as unusual and unexpected. It is supported by the 1993 transaction by which Chet purchased Mr. Barneson's shares for $150,000. Chet and Mr. Barneson - unrelated parties - reached this figure by estimating annual revenue growth for Dukes at 4% per year. Using a 4% growth rate, the shares that Chet was able to purchase via the RTP agreements would have taken between 50 and 70 years to reach an "in the money" value.
>
> We also note that the RTP agreements—though negotiated among family members—did have the characteristics of an arm's-length transaction. Both parties were motivated to reach a fair price. Lloyd and Patricia were willing to part with their shares only for $5 million—an amount which they considered sufficient for their retirement. Chet on the other hand was incentivized to drive this number down so that he could reach the "in the money" value we mentioned above sooner. This incentivized Chet both to stay with the company and to increase its per-share value.

Kress v. U.S., 382 F. Supp. 3d 820, 839 (E.D. Wis. 2019), held that Code § 2703(b)(2) does not apply to gifts (highlighting added):

> Under the second requirement, the Restriction cannot be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth." § 2703(b)(2). Citing Treasury Regulation § 25.2703-1, the Government contends that this second requirement applies not only to transfers at death but also to inter vivos transfers. See 26 C.F.R. § 25.2703-1(b)(1)(ii) ("The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth."). The Government argues that the term "decedent" in § 2703(b)(2) is ambiguous in light of the statute's place within Subtitle B, Chapter 14 of the Internal Revenue Code, which includes other valuation rules targeting transfer avoidance schemes, and thus the court should defer to the agency's interpretation of the statute.…
>
> Although Chapter 14 is intended to generally address transfer tax avoidance schemes, it is clear from the statute itself that the phrase "members of the decedent's family" unambiguously limits its application to transfers at death. See Black's Law Dictionary (10th ed. 2014) (defining "decedent" as a "dead person, especially one who has died recently"); see also *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at *6 (W.D. Pa. June 30, 2004) (noting that "one of Congress's primary concerns [in enacting § 2703(b)(2)] was the free passage of wealth to family members through a device that is testamentary in nature"). Although Congress has attempted to amend § 2703(b)(2) to conform with the agency regulations, no such legislation has been enacted. See *Smith*, 2004 WL 1879212, at *6 n.3 (citing HR Conf. Rep. 1555, 102d Cong., 1st Sess. (1991); The Revenue Bill of 1992, HR Conf. Rep. 11, 102d Cong., 2d Sess. (1992)); see also *Holman*, 601 F.3d at 781 (Bean, J., dissenting) ("I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase `members of the decedent's family' with the Commissioner's phrase `natural objects of the transferor's bounty.'").
>
> In short, I find that Congress has spoken unambiguously to the precise question at issue: § 2703(b)(2) applies specifically to transfers at death. Because Plaintiffs gifted their shares

> to their family members as living persons, they are, by definition, not decedents. Therefore, § 2703(b)(2) is satisfied. But even were I to conclude that § 2703(b)(2) does apply to inter vivos transfers, this would not change the result. For as noted above, the family transfer restrictions serve the bona fide purpose of maintaining family ownership and control of the business, and were not intended as a tax avoidance device.

One way to satisfy this exception is if the entity is not family owned, using Code § 2701 principles under Reg. § 25.2703-1(b)(3):

> A right or restriction is considered to meet each of the three requirements … if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

If the entity does not satisfy this non-family-controlled test, then one must satisfy each of the above three exceptions separately. The Code § 2703(b)(3) comparability test, which is the main test that Code § 2703 added to pre-1990 law, uses the following principles under Reg. § 25.2703-1(b)(4):

> (i) *In general*. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.
>
> (ii) *Evidence of general business practice*. Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

Kress concluded that "the estate has not shown that the terms of the Modified 1981 Agreement are comparable to similar agreements entered into by persons at arm's length, as required by section 2703(b)(3)," reasoning:

> Section 2703(b)(3) provides that the terms of a buy-sell agreement must be "comparable to similar arrangements entered into by persons in an arms' length transaction." Section 2703(b)(3) appears to contemplate a taxpayer's production of evidence of

agreements actually negotiated by persons at arm's length under similar circumstances and in similar businesses that are comparable to the terms of the challenged agreement.

The legislative history supports this interpretation. The committee report from the Senate, where section 2703 originated, states:

> In addition, the bill adds a third requirement, not found in present law, that the terms of the option, agreement, right or restrictions be comparable to similar arrangements entered into by persons in an arm's length transaction. This requires that the taxpayer show that the agreement was one that could have been obtained in an arm's length bargain. Such determination would entail consideration of such factors as the expected term of the agreement, the present value of the property, its expected value at the time of exercise, and the consideration offered for the option. It is not met simply by showing isolated comparables but requires a demonstration of the general practice of unrelated parties. Expert testimony would be evidence of such practice. In unusual cases where comparables are difficult to find because the taxpayer owns a unique business, the taxpayer can use comparables from similar businesses. [136 Cong. Rec. S15683 (daily ed. Oct. 18, 1990).]

Thus, Congress contemplated that business "comparables" that established "the general practice of unrelated parties" would constitute the evidence satisfying section 2703(b)(3), and that "expert testimony" could be used for this purpose.

The regulations under section 2703 also contemplate the introduction of evidence of actual comparable transactions. Section 25.2703-1(b)(4), Gift Tax Regs., provides in relevant part:

(4) *Similar arrangement*.

> (i) *In general* . A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business….
>
> (ii) *Evidence of general business practice* . Evidence of general business practice is not met by showing isolated comparables… It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

In light of the statutory language, the legislative history, and the regulations, we conclude that section 2703(b)(3) requires a taxpayer to demonstrate that the terms of an agreement providing for the acquisition or sale of property for less than fair market value are similar to those found in similar agreements entered into by unrelated parties at arm's length in similar businesses. In the instant case, the estate must demonstrate that the terms of the Modified 1981 Agreement are similar to terms in agreements entered into by unrelated parties in businesses similar to that of BCC.

The only evidence proffered by the estate on this point was the expert report and testimony of Mr. Grizzle. Mr. Grizzle opined that the terms of the Modified 1981 Agreement were comparable to similar arrangements entered into at arm's length within the meaning of section 2703(b)(3) because the price provided in the agreement for decedent's BCC shares was fair market value.[27] His conclusion regarding BCC's fair market value was based upon an income approach in which he postulated that BCC's value was equal to a multiple of four times earnings. He claimed that such a multiple was commonly used to value construction companies by those knowledgeable about the industry. He further claimed that such a multiple was implicit in the sale prices for three purportedly comparable companies he examined. He did not present evidence of other buy-sell agreements or similar arrangements, where a partner or shareholder is bought out by his coventurers, actually entered into by persons at arm's length. Nor did he attempt to establish that the method decedent used to arrive at his $4 million price was similar to the method employed by unrelated parties acting at arm's length.

[27] Mr. Grizzle opined that $4 million was a fair market value price for the shares as of either the date of execution of the 1996 Agreement (Nov. 11, 1996) or the date of decedent's death (Sept. 21, 1997).

If Mr. Grizzle were correct regarding the fair market value of decedent's BCC shares, section 2703(a) would not be triggered, insofar as it applies only to those agreements that set a price below fair market value, and no evidence of similar arrangements would be required. For the reasons discussed below, however, Mr. Grizzle has failed to persuade us that the purchase price for decedent's BCC shares set forth in the Modified 1981 Agreement was a fair market price, either when selected or at decedent's death. Rather, we are persuaded that the price set forth in the Modified 1981 Agreement is far below fair market value. Because Mr. Grizzle has failed to provide any evidence of similar arrangements actually entered into by parties at arm's length, as required by section 2703(b)(3), and his opinion is based solely on his belief that the purchase price for decedent's BCC shares was set at fair market value, Mr. Grizzle's conclusion that the terms of the Modified 1981 Agreement are comparable to similar agreements entered into by parties at arm's length is unsupportable.

In determining BCC's value, Mr. Grizzle relied solely on an income-based approach. Mr. Fodor, the estate's other expert, asserted that 25 percent of BCC's value should be determined using an asset-based approach. Mr. Hitchner, respondent's expert, asserted that BCC's value should be calculated by giving significant weight to an asset-based approach. We are persuaded by their testimony that some weight should be given to an asset approach. BCC was an asset-rich company, with significantly more cash than similar companies. Decedent's shares represented a controlling interest in the company, thus allowing a purchaser to control the retention or disposition of those assets. Thus, Mr. Grizzle's reliance on an income-based approach alone, without regard to the company's assets, raises doubt about his valuation judgments.

Even if we assume that an income-based approach alone were appropriate here, Mr. Grizzle excluded nonoperating assets from his valuation, on the theory that, in actual transactions, sellers do not sell nonoperating assets along with the operating assets. Thus, he envisioned decedent selling BCC's operating assets only, while retaining its nonoperating assets. The purchase price set forth in the Modified 1981 Agreement, however, was for decedent's interest in BCC's operating and nonoperating assets. As discussed infra in Part II.C.3., BCC had approximately $1.9 million of nonoperating assets (ignoring insurance proceeds the company was due to receive on decedent's death). Had Mr. Grizzle valued all of BCC's assets, and not just the operating assets, he would have valued BCC at over $6 million, as opposed to the $4.5 million value he calculated using a multiple of four times adjusted cashflow. With this adjustment alone, Mr. Grizzle's estimation of the fair market value of decedent's shares would rise from approximately $3.8 million to over $5 million, thus undermining any claim that the $4 million purchase price in the Modified 1981 Agreement was a fair market value price.[28]

[28] In addition, we are unpersuaded regarding Mr. Grizzle's estimation of BCC's fair market value because his purportedly comparable companies differed significantly from BCC. For instance, the cellular tower construction company he used as a comparable was 2 years old with minimal cash and assets. It was in a new industry that was rapidly evolving. Moreover, it depended on three customers for 86 percent of its contract revenues, with one customer accounting for 48 percent of those revenues. This is a far cry from BCC, which had been in business for more than 50 years, operated in a stable industry, obtained business from numerous sources, and had significant cash and assets. In two cases, Mr. Grizzle relied on financial data generated after the companies were sold to determine the cashflow multiple implicit in the sale prices. In each case, the use of this data served to decrease the multiple he determined. Thus, we are not persuaded by Mr. Grizzle's conclusion that BCC should be valued using the same multiple of cashflow reflected in the sales of these companies or that the multiples he derived are accurate.

In light of these concerns, we assign no weight to Mr. Grizzle's testimony that the $4 million purchase price set forth in the Modified 1981 Agreement was a fair market price value. Accordingly, his conclusion that the Modified 1981 Agreement established a price comparable to those of similar arrangements entered into at arm's length by people in similar businesses is flawed.

While we do not doubt that a corporation's redemption of a shareholder's stock that is subject to a restrictive agreement, as here, might well occur at an arm's-length price less than fair market value, the failure of Mr. Grizzle's proof leaves us only to speculate as to what such a below-fair-market-value, yet arm's-length, price might be. Decedent set a price in the 1996 Agreement that he believed was the most BCC could pay without impairing its liquidity. But this $4 million price was reached between decedent and his controlled corporation, with the remaining shareholder excluded. The best evidence we have on this record of an arm's-length arrangement involving the BCC stock is the unmodified 1981 Agreement, which was negotiated between decedent and his brother-in-law when both were 50-percent shareholders and neither knew who would survive the other. The redemption price set in that agreement was (i) book value or (ii) whatever price these two shareholders, in relatively equal bargaining positions, could annually agree upon. Given the disparity in the prices dictated in the 1981 Agreement versus the 1996 Agreement, we have no confidence that the 1996 Agreement was comparable to an arm's-length bargain.

Insofar as the estate has failed to persuade us that the Modified 1981 Agreement has met the requirements of section 2703(b)(3), the Modified 1981 Agreement must also be disregarded under section 2703(a) when determining the value of decedent's BCC shares for Federal estate tax purposes.

The Tax Court, convinced that the taxpayer's buy-sell agreement was arrived upon in a manner intended to arrive at fair market value, applied the comparability test of Code § 2703(b)(3) in *Estate of Amlie v. Commissioner*:[4633]

> For the reasons discussed below, we conclude that the estate has satisfied section 2703(b)(3). By its terms, the statute requires only a showing that the agreement's terms are "comparable" to similar arrangements entered at arm's length. While the regulations caution against using "isolated comparables", we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.
>
> In any event, the price terms reached in the 1994 Agreement, and incorporated in the 1995 FSA, were in fact based on a survey of comparables. The conservator sought professional advice from within Boatmen's, and was advised that the $118 price (1.25 times book value) was a fair price for decedent's FABG stock and Hill Rights, when coupled with the deferred sale feature of the 1994 Agreement. The deposition of the valuation specialist who advised the conservator (taken in connection with the district court proceedings) is in the record, and it indicates that the specialist considered the merger multiples for all Midwest region banks sold in the prior year and determined that, given the size, location, and profitability of Agri, book value represented the market value of Mr. Hill's FABG shares, and that the additional consideration received by Mr. Hill for his shares represented payment of a premium of 0.33 times book value. In the analyst's view, given that a portion of the premium was attributable to another of Mr. Hill's banks and certain other factors, a premium of 0.25 times book value represented fair, equivalent consideration for the Hill Rights. Thus, several comparables were in fact considered in determining the $118 price for decedent's stock in the 1995 FSA.
>
> Several other indicia in the record support the conclusion that the terms of the 1995 FSA were comparable to arrangements entered into at arm's length. The 1994 Agreement and the 1995 FSA (with their identical price terms) were not agreements reached between decedent and a member of her family. Rather, they were entered into by decedent's conservator, who had a fiduciary duty to safeguard decedent's interests. The conservator and FABG negotiated at arm's length to reach the 1994 Agreement, and the 1995 FSA adopted that agreement's price terms. On this record, we are satisfied that the negotiations among the prospective heirs to reach the 1995 FSA were also arm's length; the interests of the prospective heirs other than Rod were adverse to Rod's with respect to the price terms for the stock. As discussed above, an understated price in the 1995 FSA would have penalized the other prospective heirs.
>
> Obviously, the fact that the district court concluded in 1995 that the $118 price was inadequate, and the fact that Rod was able to secure a price of $217.50 per share from FABG in 1997, raise questions concerning whether the $118 price in the 1995 FSA was comparable to similar arrangements entered at arm's length. However, on the facts of this case, we are persuaded that the 1995 FSA price terms were arm's length. The prospective heirs other than Rod agreed to the $118 price even though they were aware of the district court proceedings where it was found inadequate. In our view, the other prospective heirs and Rod simply disagreed regarding the potential risks and rewards of further negotiation or litigation with FABG over the value of the Hill Rights.[29] In the circumstances, the other prospective heirs struck a bargain for the proverbial "bird in the

[4633] T.C. Memo. 2006-76.

hand" of a guaranteed price, transferring to Rod the benefits and burdens of the pursuit of the possible "two in the bush". It may have been a bad bargain in hindsight, but we are persuaded it was arm's length when made.

[29] See supra note 26.[4634]

A second factor also bears on our conclusion. The nub of the differing judgments on the value of the Hill Rights concerned the FACC option given to Mr. Hill. The valuation specialist consulted by the conservator concluded (in the fall of 1994) that the FACC option had no value, because of the multiple variables that might affect the relative values of the FABG and FACC stock during the 5-year period before the FACC option was exercisable (in October 1999). This view of the value of the FACC option figured prominently in the valuation specialist's conclusion that the $118 price was fair. Rod's experts disagreed and convinced the district court that the FACC option had significant value.

We are persuaded that the value of the FACC option became easier to discern over time, as the exercise date drew nearer, and that later in the 5-year option period it became clear that FACC stock would be more valuable than FABG stock on the exercise date, rendering the FACC option more valuable. Indeed, the parties have stipulated that FABG was willing to pay more for decedent's FABG stock in 1997 than it offered in connection with the 1994 Agreement because of the higher value FABG assigned to the Hill Rights in 1997. Thus, the disparity in the $217.50 per-share price obtained for the stock by Rod in August 1997 and the $118 per-share price in the 1995 FSA is attributable, at least in part, to the passage of time and the apparent appreciation of the FACC stock in relation to the FABG stock over that period, and not to any deliberate undervaluing of the stock in the 1995 FSA. This factor bolsters the conclusion that the terms of the 1995 FSA are comparable to similar arrangements that would have been entered at arm's length. The value of the FACC option was less clear in 1995, and

[4634] [my footnote:] Footnote 26 says:

> We agree with the conservator's view that decedent and/or her estate faced significant litigation hazards in this regard. We believe FABG possessed leverage on the basis of the 1991 Agreement provision under which decedent was required to sell her minority stake to any purchaser of the controlling stake if the purchaser conditioned his purchase of the controlling stake on his acquisition of decedent's shares. Also, an official of FABG testified in the proceedings concerning approval of the 1994 Agreement that if the 1994 Agreement were rejected, FABG would take the position that it was entitled, as Agri's successor, to purchase decedent's stock pursuant to the call option in the 1991 Agreement for book value. (This call option was exercisable at decedent's death, and decedent was 92 at the time of the proceedings concerning the 1994 Agreement.) Finally, further negotiations and/or litigation with FABG jeopardized the conservator's goal of avoiding capital gains taxes on the sale of decedent's FABG stock. See supra note 25.
>
> In addition, we are persuaded that the value of the Hill Rights was especially uncertain, in light of the FACC option, the value of which was the subject of conflicting expert testimony in the district court proceedings concerning approval of the 1994 Agreement.

Footnote 25 says:

> The conservator also sought to achieve an additional goal in the 1994 Agreement to benefit decedent's interests; namely, the avoidance of capital gains tax liability on the sale of the FABG stock. The 1991 Agreement did not confer any right to defer the sale (until death) of decedent's stock in the event of a sale of the controlling interest in Agri. In providing that FABG's call option was not exercisable until after decedent's death, the 1994 Agreement also implemented the conservator's goal regarding capital gains tax liability.

> the conservator (as decedent's fiduciary) and the prospective heirs other than Rod preferred to secure an agreement in 1995 rather than risk a protracted dispute with FABG, for the reasons previously discussed.
>
> Finally, FABG's purchase of the FABG stock from the Rod Amlie Family pursuant to the 1997 Rod Amlie Family Agreement was conditioned upon the sale by Rod's wife Sally of certain other FABG stock that she owned in her own right, suggesting that the 1997 price was also affected by FABG's desire to obtain additional stock in the hands of another minority holder.

Huffman v. Commissioner, T.C. Memo. 2024-12, commented:

> This Court has described the final prong of the section 2703(b) exception as "more of a safe harbor than an absolute requirement that multiple comparables be shown." *Estate of Morrisette*, T.C. Memo. 2021-60, at *103 (quoting *Estate of Amlie*, T.C. Memo. 2006-76, slip op. at 41). It is therefore permissible to use an isolated comparable to establish that section 2703(b)(3) is satisfied. *Estate of Amlie*, T.C. Memo. 2006-76, slip op. at 41.

The court then held that the comparability test was not satisfied:

> Petitioners argue that the final section 2703(b) requirement is satisfied by the Lloyd-Barneson agreement, which they claim is comparable to the RTP agreements and was entered into in an arm's-length transaction. Petitioners note that the Lloyd-Barneson agreement contained the following provisions, which are also included in the RTP agreements: (1) a right to purchase on the death of the grantor and by a right of first refusal; (2) a maximum purchase price; and (3) no specific termination or exercise date. Petitioners also point out that the Lloyd-Barneson agreement was entered into by unrelated parties - Lloyd and Mr. Barneson - and executed at arm's length.
>
> Respondent counters that the Lloyd-Barneson agreement cannot serve as a good comparable because it was not submitted into evidence. Respondent notes that there are only two pieces of evidence which describe the Lloyd-Barneson agreement: a one-paragraph reference in the Assignment agreement and another in the Chet-Barneson agreement. Otherwise, the only information provided about the Lloyd-Barneson agreement comes from witnesses' testimony, which made vague references to the agreement.
>
> Respondent contends that even if we are to find that the testimony regarding the Lloyd-Barneson agreement is credible, there are differences among it and the RTP agreements which render the Lloyd-Barneson agreement not a good comparable. The noted differences are that (1) Lloyd Huffman was allowed to freely transfer his rights whereas Chet had to obtain consent from the owners; (2) the right of first refusal in the RTP agreements exempted offers from Chet's brothers; (3) the RTP agreements had an addendum that granted Chet the right to purchase the shares at any time at his discretion; and (4) the stated purpose of the RTP agreements was to retain ownership of Dukes within the Huffman family.
>
> We agree with respondent. As we noted in *Estate of Amlie*, T.C. Memo. 2006-76, slip op. at 41, reliance on an isolated comparable is adequate given that the regulations "delineate more of a safe harbor than an absolute requirement that multiple comparables be shown." Use of the Lloyd-Barneson agreement then would be acceptable to show

> that the RTP agreements had terms similar to an agreement entered into at arm's-length. But as respondent notes, we do not have the Lloyd-Barneson agreement in evidence. We have only vague and incomplete references to it and testimony based on those references. We do not have an isolated comparable to undergo the section 2703(b)(3) analysis.
>
> Even if we were to accept witnesses' testimony as sufficient evidence, we do not think that the Lloyd-Barneson agreement is sufficiently similar. Even though the three agreements purport to create rights to purchase Dukes shares for a maximum price, the differences among them are significant. For example, Chet had the unfettered right to purchase the Dukes shares at any time and at his sole discretion; Lloyd did not have this same right. Further, Lloyd was permitted to assign or otherwise transfer his purchase rights whereas Chet had to obtain consent to do the same. Chet then had rights superior to Lloyd's in purchasing the shares but inferior in transferring those rights. The terms of the agreements are therefore not comparable within the meaning of section 2703(b)(3).
>
> On the basis of the foregoing, we do not think that petitioners have satisfied the final requirement of section 2703(b). *See Estate of Blount v. Commissioner*, T.C. Memo. 2004-116, slip op. at 48 (finding that solely testimony without production of comparable agreements was insufficient to satisfy section 2703(b)(3)), *aff'd in part, rev'd in part and remanded*, 428 F.3d 1338 (11th Cir. 2005). Section 2703(b) is therefore not satisfied, and so the RTP agreements must be disregarded for purposes of valuing the Dukes shares that Chet purchased in 2007. See § 2703(a).

The court's description of *Blount* in the paragraph above is somewhat misleading. Please read the extensive quote from *Blount* about reliance on expert testimony. Unfortunately, the taxpayer in *Huffman* relied almost exclusively on one comparable and did not have the appraiser present evidence about other comparables beyond mere brief testimony.

Given that contemporaneous evidence tends to be the most probative, when drafting, reviewing, or revising a buy-sell agreement where trying to set estate tax values is important, consider gathering proof that its terms are comparable to similar arrangements entered into by persons in an arms' length transaction. Some opportunities to consider in light of *Huffman* include:

- *Drafting the agreement*.
  - Preserve the original form. I copy the form into a new document and save all edits to new versions of that new document, so I can always see how I varied from the form.
  - Document the business reasons for any variations from the form.
  - If the agreement is based on a forms service:
    - Document who the authors are.
    - Document what the authors say about the provisions being used in commercial (non-estate-planning) settings and any objective support for those statements.
  - If the agreement is based on internal forms, document whether the form is used in agreements with third parties.

- Although knowing all of the above is good for the overall document, focus more on the buy-sell provisions.

- *Obtaining appraisals*.

  - Each time an appraiser values a business interest, ask how the buy-sell provisions compare to other buy-sell provisions the appraiser has seen in agreements between unrelated third parties.

  - See whether the appraiser is comfortable discussing in the report how the buy-sell provisions compare to other companies that size in the same industry (which would be ideal but often is not practical), to other companies of that size with similar ownership structure among unrelated owners, or to anything else that may be reasonable and meaningful.

The bona fide and comparability tests are somewhat intertwined. The Tax Court seems to be saying that, not only does the agreement itself need to be intended to yield a fair market value sale, but also the comparable clauses need to be designed to reach a fair market value result. For example, in *Blount*, a multiple of cashflow was a reasonable approach, but the Tax Court rejected the multiple used and also cited inconsistency regarding the impact of nonoperating assets. As to the latter, the buy-sell formula was based on a sale of only operating assets, but the actual sale was for operating and nonoperating assets.

Even if the above rules are not complied with, obligations do tend to affect a stock's marketability,[4635] in that they cloud the business' future operations.[4636] In reversing the Tax Court,[4637] *Estate of Blount*, 428 F.3d 1338 (11th Cir. 2005) held:

> To establish the fair market value of BCC, the Tax Court blended the analyses of the experts to arrive at a value of $6.75 million. The IRS and the Taxpayer, albeit alternatively, agree that this is the base value for the assets and liabilities of BCC as of the date of Blount's death. We accept the accuracy of this value as not clearly erroneous. The Tax Court then added the insurance proceeds that BCC would receive on Blount's death to the value of the company, concluding that the value of BCC would have been $9.85 million. In doing so, the Tax Court erred.
>
> In valuing the corporate stock, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent that such nonoperating assets have not been taken into account in the determination of net worth." Treas. Reg. § 20.2031-2(f)(2). The limiting phrase, "to the extent that such nonoperating assets have not been taken into account," however, precludes the inclusion of the insurance proceeds in this case. In *Cartwright v. Commissioner*, the Ninth Circuit approved deducting the insurance proceeds from the value of the organization when they were offset by an obligation to pay those proceeds

[4635] Rev. Rul. 77-287 explains valuation adjustments due to stock being restricted from resale pursuant to Federal securities laws.
[4636] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004), citing *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, for the concept that, even if a provision does not bind the IRS as to estate tax value, it can still affect its value.
[4637] T.C. Memo. 2004-116.

to the estate in a stock buyout. 183 F.3d 1034, 1038 (9th Cir. 1999)[5]; see also *Huntsman v. Comm'r*, 66 T.C. 861, 875 (1976)[6].

[5] The Ninth Circuit observed that the Tax Court "properly determined that [the] insurance policy would not necessarily affect what a willing buyer would pay for the firm's stock because it was offset dollar-for-dollar by [the] obligation to pay out the entirety of the policy benefit's to [the] estate." *Cartwright*, 183 F.3d at 1038.

[6] The Tax Court focused on the word "consideration" to make its judgment about including life insurance proceeds: "The Commissioner argues that our interpretation of section 20.2031-2(f), Estate Tax Regs., frustrates the clear intent of Congress to include corporate-owned life insurance in the estate of its sole shareholder. See H. Rept. No. 2333, 77th Cong., 1st Sess. (1942), 1942-2 C.B. 372, 491; S. Rept. No. 1631, 77th Cong., 2d Sess. (1942) 1942-2 C.B. 504, 677. However, the statements in the legislative history relied upon by the Commissioner indicate only that Congress believed that a sole shareholder was deemed to have the incidents of ownership possessed by his corporation on insurance policies on his life. The regulations now provide that the incidents of ownership held by a corporation are not to be attributed to its shareholder, and no indication is included in the committee reports that Congress intended property owned by a decedent to be includable in his gross estate at other than its fair market value. Consequently, our interpretation of such section does not frustrate a congressional intent. In accordance with section 20.2031-2(f), Estate Tax Regs., we must determine the fair market value of the decedent's stock in the two corporations by applying the customary principles of valuation and by giving "consideration" to the insurance proceeds." *Huntsman*, 66 T.C. at 875–76.

The rationale in *Cartwright* is persuasive and consistent with common business sense. BCC acquired the insurance policy for the sole purpose of funding its obligation to purchase Blount's shares in accordance with the stock-purchase agreement. Even when a stock-purchase agreement is inoperative for purposes of establishing the value of the company for tax purposes, the agreement remains an enforceable liability against the valued company, if state law fixes such an obligation.[7] Here the law of Georgia required such a purchase.

[7] Other courts have found - when the restrictive agreement is an attempt to effect a testamentary transfer and avoid the estate tax - that honoring a restrictive element in determining fair market value would be improper. See *True v. Comm'r*, 390 F.3d 1210, 1239-41 (10th Cir. 2004) (listing cases that honor restrictive clauses in determining value and cases that do not honor such restrictive clauses). The IRS urges us to adopt the broadest rule that, when an agreement is ignored for valuation purposes, the agreement plays no role in determining the fair market value. We decline to do so because, as proved by this case, such a rule is overinclusive and represents a manifest departure from common business (i.e., market) sense.

Thus, we conclude that the insurance proceeds are not the kind of ordinary nonoperating asset that should be included in the value of BCC under the treasury regulations. To the extent that the $3.1 million insurance proceeds cover only a portion of the Taxpayer's 83% interest in the $6.75 million company, the insurance proceeds are offset dollar-for-dollar by BCC's obligation to satisfy its contract with the decedent's estate. We conclude that such nonoperating "assets" should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets. To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value.

> **III. CONCLUSION**
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> The Tax Court properly determined that the 1981 agreement, as amended by the 1996 agreement, had no effect for purposes of determining the value of the BCC shares in Blount's estate and that the fair market value of the corporation was the proper basis for tax assessment. The Tax Court erred when it ignored the amended agreement's creation of a contractual liability for BCC, which the insurance proceeds were committed to satisfy. We reject the Tax Court's inclusion of the insurance proceeds paid upon the death of the insured shareholder as properly included in the computation of the company's fair market value. We remand for disposition consistent with this opinion.

I cannot reconcile the Eleventh Circuit's opinion with the regulations. I believe that the Eleventh Circuit stretched to do justice, in that the benefit of the reduced purchase price went to an ESOP that generally was not for the benefit of the decedent's family. Reviewing footnote 7 above, the court acknowledged that "when the restrictive agreement is an attempt to effect a testamentary transfer and avoid the estate tax … honoring a restrictive element in determining fair market value would be improper," but added that such a result would defy common sense in this case.

Connelly v. U.S., 128 A.F.T.R.2d 2021-5955 (E.D. MO 9/21/2021), agreed with the Tax Court's reasoning and disagreed with the Eleventh Circuit's opinion in *Blount*:

> The Estate urges that the fair market value of Crown C does not include the $3 million in life-insurance proceeds at issue because those proceeds "were off-set dollar for dollar by the obligation to redeem [Michael's] shares" under the Stock Agreement. Doc. 65. According to the Estate, a hypothetical "willing buyer" of Crown C would have to account for substantial liabilities like Crown C's redemption obligation. See, *e.g.*, *Estate of Dunn v. C.I.R.*, 301 F.3d 339, 352 (5th Cir. 2002) (the value of a corporation's assets is discounted by the corporation's capital-gains liability); *Eisenberg v. Comm'r*, 155 F.3d 50, 57 (2d Cir. 1998) (a hypothetical buyer would pay less for shares in a corporation because of the buyer's "inability to eliminate the contingent tax liability"). The Estate emphasizes that a willing buyer would pay less for a company encumbered with a stock-purchase agreement, to account for the company's future decrease in assets when fulfilling the contractual obligation. See *Estate of Blount*, 428 F.3d at 1346.
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> The parties agree that the facts of this case present the same fair-market-value issue as *Estate of Blount*, 2004 WL 1059517, at *26 (T.C. 2004), *aff'd in part*, *rev'd in part*, 428 F.3d 1338 (11th Cir. 2005). Doc. 52 at 12; Doc. 46 at 6–7. In *Estate of Blount*, a closely-held family company entered into a stock purchase agreement with its shareholders, intending that the company would use life-insurance proceeds to redeem a key shareholder's shares upon his death. 428 F.3d at 1340. When one of the shareholders died, his estate argued that the life-insurance proceeds should not be included in the value of the company, for purposes of determining fair market value of the redeemed shares, because of the company's offsetting contractual obligation to redeem those shares from the estate. *Id*. at 1345.
>
> The Tax Court in *Estate of Blount* included the life-insurance proceeds in the value of the company and the shareholders' shares, determining that the redemption obligation was

not like an ordinary liability because the redemption involved the very same shares being valued. 2004 WL 1059517, at *26. The Eleventh Circuit reversed on this issue, holding that the fair market value of the closely-held corporation did not include life-insurance proceeds used to redeem the shares of the deceased shareholder under a stock purchase agreement. *Estate of Blount*, 428 F.3d at 1346. The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life-insurance proceeds. *Id*. at 1345-46. The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate." *Id*. at 1346 (citing 26 C.F.R. § 20.2031-2(f)(2)).

The IRS urges the Court to reject the Eleventh Circuit's holding in *Estate of Blount* and apply the Tax Court's reasoning. Doc. 52 at 12–14. The IRS contends that the Eleventh Circuit's approach violates customary valuation principles, resulting in a below-market valuation for Crown C and a windfall for Thomas at the expense of Michael's estate. *Id*. According to the IRS, a willing buyer and seller would value Crown C at approximately $6.86 million, rather than $3.86 million, because on the date of Michael's death, Crown C possessed the $3 million in life-insurance proceeds that were later used to redeem Michael's shares. *Id*. at 19. This, in turn, would make Michael's 77.18% interest in Crown C worth about $5.3 million. *Id*. The Estate disagrees, somewhat reflexively arguing that under the Eleventh Circuit's holding in *Estate of Blount*, the Court should not include the $3 million in life-insurance proceeds in the valuation of Crown C because of the redemption obligation in the Stock Agreement. Doc. 46 at p. 6. But other than citing the Eleventh Circuit's holding and its own expert opinions (which essentially say that holding controls), the Estate does not really explain why it believes the Eleventh Circuit's holding is correct. *Id.*

Life-insurance proceeds are nonoperating assets that generally increase the value of a company. 26 C.F.R. § 20.2031-2(f)(2); *Estate of Huntsman*, 66 T.C. at 874. Here, the parties agree that the proceeds are a nonoperating asset that would have increased Crown C's value, but they dispute whether Crown C's redemption obligation was a liability that offset the proceeds for valuation purposes. Doc. 52 at pp. 14-15; Doc. 46 at pp. 5-6. Therefore, to determine the fair market value of Michael's shares as of the date of his death, the Court analyzes whether Crown C's outstanding redemption obligation was a corporate liability that reduced the fair market value of Crown C.

Under the willing-buyer-willing-seller principle, a redemption obligation does not reduce the value of a company as a whole or the value of the shares being redeemed. A redemption obligation requires a company to buy its own shares from a shareholder, and just like any other contractual obligation, a redemption obligation expends company resources. But as the Tax Court observed in *Estate of Blount*, a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued." 2004 WL 1059517, at *25.

Consider what a hypothetical "willing buyer" would pay for a company subject to a redemption obligation. See 26 C.F.R. § 20.2031-1(b). The willing buyer would not factor the company's redemption obligation into the value of the company, because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation; in other words the buyer would pay all of the shareholders the fair market value for all of their shares. The company, under the buyer's new ownership, would then be obligated to redeem shares that the buyer now holds. Since the buyer would receive the payment from the stock redemption, the buyer would not consider the obligation to himself as a liability that lowers the value of the company to him. See *Estate of Blount*, 2004 WL 1059517, at *25 (T.C. 2004) ("To treat the corporation's obligation to redeem the very shares that are being valued as a liability that reduces the value of the corporate entity thus distorts the nature of the ownership interest represented by those shares.").

A willing buyer purchasing Crown C on the date of Michael's death would not demand a reduced purchase price because of the redemption obligation in the Stock Agreement, as Crown C's fair market value would remain the same regardless. The willing buyer would buy all 500 of Crown C's outstanding shares (from Michael's Estate and Thomas) for $6.86 million, acquiring Crown C's $3.86 million in estimated value plus the $3 million in life-insurance proceeds at issue. If Crown C had no redemption obligation, the willing buyer would then own 100% of a company worth $6.86 million.

But even with a redemption obligation, Crown C's fair market value remains the same. Once the buyer owned Crown C outright, the buyer could either: 1) cancel the redemption obligation to himself and own 100% of a company worth $6.86 million, or 2) let Crown C redeem Michael's former shares - the buyer (and not Michael's Estate) would receive roughly $5.3 million in cash and then own 100% of a company worth the remaining value of about $1.56 million, leaving the buyer with a total of $6.86 million in assets. Therefore, with or without the redemption obligation, the fair market value of Crown C on the date of Michael's death was $6.86 million.

The Estate urges the Court to follow the Eleventh Circuit's reasoning in *Estate of Blount*, which declared that "nonoperating assets should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets." 428 F.3d at 1346 (quotation marks omitted). But as the IRS points out, the Court must determine the fair market value of Crown C on the date of Michael's death, not the value in its post-redemption configuration. See 26 U.S.C. § 2031. Excluding the insurance proceeds from Crown C's value impermissibly treats Michael's shares as both outstanding and redeemed at the same time, reducing Crown C's value by the redemption price of the very shares whose value is at issue. This approach ignores the ownership interest represented by Michael's shares; construing a redemption obligation as a corporate liability only values Crown C post redemption (*i.e.*, excluding Michael's shares), not the value of Crown C on the date of death (i.e. including Michael's shares).

Demonstrating this point, exclusion of the insurance proceeds from the fair market value of Crown C and valuing Michael's shares at $3 million results in drastically different share prices for Michael's shares compared to Thomas's. If on the date of his death, Michael's 77.18% interest was worth only $3 million ($7,774/share), that would make Thomas's 22.82% interest worth $3.86 million ($33,863/share) because Thomas owned all other outstanding shares and the residual value of Crown C was $3.86 million. See Doc. 53-19 at ¶ 61. The residual value of Crown C is the value of the company apart from the $3 million of insurance proceeds at issue. The parties have agreed that this value was $3.8 million. Doc. 48 at ¶¶ 1–3; Doc. 58 at ¶¶ 43, 79–81. Because Thomas was the only other shareholder of Crown C, his ownership interest must therefore equal the residual value of Crown C: $3.8 million. This outcome violates customary valuation principles because Thomas's shares would be worth 336% more than Michael's at the exact same time. See Doc. 53-19 at ¶ 61. A willing seller of Michael's shares would not accept this bargain, as it creates a windfall for the buyer (Crown C of which Thomas would now have 100% control), while undervaluing Michael's shares in comparison.

Only by including the insurance proceeds in the fair market value of Crown C do Michael's and Thomas's shares hold an equal value on the date of Michael's death. Michael's 77.18% interest in a $6.86 million company would be worth $5.3 million ($13,782/share) and Thomas's 22.82% interest would be worth $1.56 million ($13,782/share). This outcome tracks customary valuation principles, because the brothers' shares have the same value-per-share. A willing seller of Michael's shares would only accept this outcome, because it assigns the same value to Michael's shares as to Thomas's and neither party's economic position changes through the transaction.

The Eleventh Circuit declared in *Estate of Blount* that 26 C.F.R. § 20.2031-2(f)(2) precludes the inclusion of insurance proceeds in the corporate value when the proceeds are used for a redemption obligation. 428 F.3d at 1345 ("The limiting phrase, 'to the extent that such nonoperating assets have not been taken into account,' however, precludes the inclusion of the insurance proceeds in this case." (citing 26 C.F.R. § 20.2031-2(f)(2))). But, 26 C.F.R. § 20.2031-2(f)(2) begins with a discussion of the factors considered in determining the fair market value of a closely-held corporation, including "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors." The regulation goes on to state that "[i]n addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth." *Id.*

While in *Estate of Huntsman* the Tax Court ultimately rejected the Commissioner's valuation as not following customary valuation principles, the court found this regulation to mean that the court "must determine the fair market value of the decedent's stock...by applying customary principles of valuation and by giving 'consideration' to the [life-]insurance proceeds." 66 T.C. at 875. The Eleventh Circuit's holding in *Estate of Blount* notwithstanding, the text of the regulation does not indicate that the very presence of an offsetting liability means that the life-insurance proceeds have already been "taken into account in the determination of a company's net worth." See 26 C.F.R. § 20.2031-2(f)(2). By its plain terms, the regulation means that the proceeds should be considered in the same manner as any other nonoperating asset in the calculation of the fair market value of a company's stock. See id. And as already discussed, a redemption obligation is not the same as an ordinary corporate liability. See supra at pp. 29–31.

The Eleventh Circuit's opinion in *Estate of Blount* relied heavily on *Estate of Cartwright*, 183 F.3d 1034, 1037 (9th Cir. 1999), which excluded insurance proceeds from the fair market value of a company when the proceeds were offset by an obligation to pay those proceeds to a shareholder's estate. *Estate of Blount*, 428 F.3d at 1345. But *Estate of Cartwright* is distinguishable. As the Tax Court in *Estate of Blount* explained about *Estate of Cartwright*:

> The lion's share of the corporate liabilities in that case which were found to offset the insurance proceeds were *not obligations of the corporation to redeem its own stock*. Rather, we determined that approximately $4 million of the $5 million liability of the corporation was to compensate the decedent shareholder for services; *i.e.*, for his

> interest in work in progress. Thus, a substantial portion of the liability was no different from any third-party liability of the corporation that would be netted against assets, including insurance proceeds, to ascertain net assets.

2004 WL 1059517, at *27 (emphasis added). Unlike in *Estate of Cartwright*, Crown C's redemption obligation simply bought Michael's shares. See *id*. The redemption did not compensate Michael for his past work, so it was not an ordinary corporate liability. See *Estate of Blount*, 2004 WL 1059517, at *27 (T.C. 2004). While some of the life-insurance proceeds in *Estate of Cartwright* were used for a stock redemption, *Estate of Cartwright* mainly discussed how the insurance proceeds compensated the shareholder for past work, not for his shares in the company. See *Estate of Cartwright* , 1996 WL 337301, at *7-8 (T.C. 1996), *aff'd in part, rev'd in part by*, 183 F.3d 1034, 1037-38 (9th Cir. 1999). And to the extent that *Estate of Cartwright* excluded some of the life-insurance proceeds from the company's fair market value because of an offsetting redemption obligation, the opinion contains the same analytical flaw as *Estate of Blount*, 183 F.3d at 1037, *i.e*. considering a redemption obligation to be a corporate liability that depresses a company's value by ignoring the ownership interest represented by the redeemed shares.

The Court finds the Tax Court's reasoning in *Estate of Blount* persuasive. *Estate of Blount*, 2004 WL 1059517, at *24-27; *see also* Adam S. Chodorow, *Valuing Corporations for Estate Tax Purposes: A Blount Reappraisal*, 3 Hastings Business Law Journal 1, 25 (2006) ("Taking redemption obligations into account leads the court to value the wrong property...redemption obligations are different from other types of corporate obligations in that a redemption obligation both shrinks the corporate assets and changes its ownership structure."). A redemption obligation is not an ordinary corporate liability - a stock redemption involves a change in the ownership structure of the company, where the company buys a shareholder's interest - so a redemption obligation does not change the value of the company as a whole before the shares are redeemed. Nor can a redemption obligation diminish the value of the same shares being redeemed; the shareholder is essentially "cashing out" his share of ownership in the company and its assets. Moreover, a stock redemption results in the company (and more specifically its remaining shareholder(s)) getting something of equal value for the cash spent, *i.e.* the decedent's share of ownership in the company; the exchange increases the ownership interest for each of the company's outstanding shares, *i.e.* the surviving shareholders' shares.

For these reasons, the Court respectfully finds that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." *Keasler v. United States*, 766 F.2d 1227, 1233 (8th Cir. 1985) ("[T]he tax decisions of other circuits should be followed unless they are demonstrably erroneous or there appear cogent reasons for rejecting them." (internal quotation marks and citation omitted)). Accordingly, the Court holds that the $3 million in life-insurance proceeds used to redeem Michael's shares must be included in the fair market value of Crown C and of Michael's shares.

Connelly hypothesized that a buyer would buy 100% before buying the decedent's interest. Hypothesizing a strategic buyer is reversible error, unless that part of the opinion can be disregarded and the rest of the opinion holds together. Query how the court will value the decedent's stock. If the buy-sell agreement is disregarded, will the resulting liquidity also be disregarded? In that case, the stock needs to be valued based on lack of marketability and how much control a hypothetical willing buyer of the company's stock would have over the company.

In affirming the District Court, among its reasons the Eighth Circuit, 70 F.4th 412 (2023) reasoned:

> Generally, the value of any property for tax purposes is determined "without regard to any option, agreement, or other right to acquire...the property at a price less than the fair market value" or to "any other restriction on the right to sell or use such property." 26 U.S.C. §§ 2703(a). These sorts of agreements are commonly used by closely held corporations to keep control among a small group of people. *See* 3 James D. Cox & Thomas Lee Hazen, *Treatise on the Law of Corporations* § 18:13 (3d ed. Dec. 2022 update). Section 2703(a) tells us to ignore these agreements unless they meet the criteria in subsection (b). Under § 2703(b), to affect valuation, the agreement must (1) be a bona fide business arrangement, (2) not be a device to transfer property to members of the decedent's family for less than full and adequate consideration, and (3) have terms that are comparable to other similar arrangements entered into in arm's length transactions. Here, the estate argues that we should look to the stock-purchase agreement to value Michael's shares because it satisfies these criteria.
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> But the estate glosses over an important component missing from the stock-purchase agreement: some fixed or determinable price to which we can look when valuing Michael's shares. After all, if § 2703 tells us when we may "regard" agreements to acquire stock "at a price less than the fair market value," we naturally would expect those agreements to say *something* about value in a definite or calculable way. *See Est. of Lauder v. Comm'r*, 64 T.C.M. (CCH) 1643, 1656 (1992) ("It is axiomatic that the offering price must be fixed and determinable under the agreement."); *see also Est. of Amlie v. Comm'r*, 91 T.C.M. (CCH) 1017, 1027 (2006) (reviewing the comparability of price terms to determine whether the agreement satisfied § 2703(b)(3)). Otherwise, why look to the agreement to value the shares?
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> Further, the Treasury regulation that clarifies how to value stock subject to a buy-sell agreement refers to the price in such agreements and "[t]he effect, if any, that is given to the...price in determining the value of the securities for estate tax purposes." 26 C.F.R. § 20.2031-2(h). The regulation also states that "[l]ittle weight will be accorded a price" in an agreement where the decedent was "free to dispose of" the securities at any price during his lifetime. *Id*. Courts thus recognize that an agreement must contain a fixed or determinable price if it is to be considered for valuation purposes. *Est. of Blount v. Comm'r*, 428 F.3d 1338, 1342 (11th Cir. 2005); *Est. of True v. Comm'r*, 390 F.3d 1210, 1218 (10th Cir. 2004); *Est. of Gloeckner v. Comm'r*, 152 F.3d 208, 213 (2d Cir. 1998); *see also St. Louis Cnty. Bank v. United States*, 674 F.2d 1207, 1210 (8th Cir. 1982) (describing when restrictive buy-sell agreements "may *fix the value* of property for estate-tax purposes" (emphasis added)). Congress enacted § 2703 against the backdrop of 26 C.F.R. § 20.2031-2(h), which has remained substantially unchanged, and courts have since interpreted the two in tandem. *See Amlie*, 91 T.C.M. (CCH) at 1024 ("[R]egardless of whether section 2703 applies to a restrictive agreement, the agreement must satisfy the requirements of pre-section-2703 law to control value for Federal estate tax purposes."); *Blount*, 428 F.3d at 1343 n.4 ("[C]ourts generally agree that the limitation in...§ 2703 should be read in conjunction with the court-created rule."); *True*, 390 F.3d at 1231 (describing § 2703 as "essentially codif[ying] the rules laid out in § 20.2031-2(h)" that had existed before § 2703 was added in 1990).

We need not resolve the precise contours of what counts as a fixed or determinable price because, wherever that line may be, the stock-purchase agreement here falls short given that the brothers and Crown ignored the agreement's pricing mechanisms. It suffices for our purposes to think of a determinable price as one arrived at by "formula," *see Gloeckner*, 152 F.3d at 213, as by a "fair, objective measure," *see Lauder*, 64 T.C.M. (CCH) at 1659, or "calculation," *see True*, 390 F.3d at 1213.

Here, the stock-purchase agreement fixed no price nor prescribed a formula for arriving at one. It merely laid out two mechanisms by which the brothers might agree on a price. One was the Certificate of Agreed Value, which appears to be nothing more than price by "mutual agreement" - essentially, an agreement to agree. The other was an appraisal process for determining the fair market value of Crown. Although this second mechanism seems to carry more objectivity, there is nothing in the stock-purchase agreement, aside from minor limitations on valuation factors, that fixes or prescribes a formula or measure for determining the price that the appraisers will reach. Instead, the agreement required only that the appointed appraisers "independently determine and submit" their "appraisal[s] of the fair market value of the Company." The brothers were then supposed to average the results or consult a third appraiser as a tiebreaker. None of this was ever done. *See St. Louis Cnty. Bank*, 674 F.2d at 1211 (noting that upon death, the provisions of the stock-purchase agreement were not invoked and that post-death conduct may be relevant to understanding the nature of the agreement). Thus, "under the circumstances of th[is] particular case," neither price mechanism constituted a fixed or determinable price for valuation purposes. *See* 26 C.F.R. § 20.2031-2(h). If anything, the appraisal mechanism calls for a rather ordinary fair-market-value analysis, which § 2031 and § 2073(a) essentially require anyway. Nothing therefore can be gleaned from the stock-purchase agreement.[3]

[3] The estate does not argue that the stock-purchase agreement otherwise controls the fair market value of Crown by virtue of its restriction on the transfer of shares (i.e., through non-price-related means). *Compare* § 2703(a)(2), *with* § 2703(a)(1). And even if we understood the estate to make this argument, we find it indistinguishable from the estate's fair-market-value argument that we address in Part II.B below.

Thomas tries to get around this problem by directing us to the price fixed by the redemption transaction - the $3 million that Crown actually paid for Michael's shares. In his view, this is an appropriate valuation because the redemption transaction links back to the stock-purchase agreement and was done pursuant to it. We are not convinced. For one, the $3 million price was chosen *after* Michael's death. *See* 26 U.S.C. §§ 2031(a) (requiring that value be determined "at the time of [the decedent's] death"); *True*, 390 F.3d at 1218 (noting that "the terms of the agreement [must be] binding throughout life and death"). And second, the $3 million price came not from the mechanisms in the stock-purchase agreement but rather from Thomas and Michael Connelly, Jr.'s "amicable agreement" resolving outstanding estate-administration matters. Thus, Crown's value must be determined "without regard" to the stock-purchase agreement. See § 2703(a)….

We now consider the fair market value of Michael's shares. The key question is whether the life insurance proceeds received by Crown and intended for redemption should be taken into account when determining the corporation's value at the time of Michael's death.[4] Two principles guide the analysis. The first deals with valuing property in general, and the second addresses companies whose stock prices cannot be readily determined from an exchange, as is the case with closely held corporations.

[4] We focus on this moment in time - after Michael's death but before his shares are redeemed. See *Bright's Est. v. United States*, 658 F.2d 999, 1006 (5th Cir. 1981) (en banc) ("[T]he estate tax is an excise tax on the transfer of property at death and accordingly ... the valuation is to be made as of the moment of death and is to be measured by the interest that passes, as contrasted with the interest held by the decedent before death or the interest held by the legatee after death."). Regardless of the timing, no one argues that the proceeds were ever in doubt. Crown expected to receive $3.5 million from the policy, most of which would be used to buy Michael's shares.

Generally, the value of property in the gross estate is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." 26 C.F.R. § 20.2031-1(b); see also *United States v. Cartwright*, 411 U.S. 546, 551 (1973) ("The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves ... .").

To this end, for closely held corporations, the share value "shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange." 26 U.S.C. § 2031(b). Treasury regulations have interpreted this as a "fair market value" analysis. 26 C.F.R. § 20.2031-2(a). The fair market value depends on the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors like "the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; [and] the degree of control of the business represented by the block of stock to be valued." 26 C.F.R. § 20.2031-2(f)(2); see also *Est. of Huntsman v. Comm'r*, 66 T.C. 861, 876 (1976) ("[W]e ... determine the fair market value of the decedent's stock ... by applying the customary principles of valuation ... ."). Setting aside for the moment the life insurance proceeds used to redeem Michael's shares, so far as Crown's operations, revenue streams, and capital are concerned, we know its value - about $3.86 million. See supra n.2.

But in valuing a closely held corporation, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity." 26 C.F.R. § 20.2031-2(f)(2). This need to "take[] into account" life insurance proceeds appears again in a nearby regulation, 26 C.F.R. § 20.2042-1(c)(6). That regulation clarifies 26 U.S.C. § 2042, which has to do with life insurance proceeds that go to beneficiaries other than the decedent's estate. Understanding the relationship between § 2031 (defining the gross estate) and § 2042, along with their corresponding regulations, helps further illuminate what it means to "take[] into account" life insurance proceeds.

Section 2042 says that the value of a decedent's gross estate includes life insurance proceeds received directly by the estate as well as proceeds received by other beneficiaries under insurance policies in which the decedent "possessed at his death any of the incidents of ownership." For example, if Michael obtained a life insurance policy for the benefit of Crown, the value of that policy's proceeds would be included in Michael's gross estate. See § 2042(2). Yet here, Crown obtained the policy for its own benefit.

Now, there might be a plausible argument that under § 2042 Michael possessed "incidents of ownership" in the life insurance policy through his controlling-shareholder status. If that were the case, then § 2042 would require that Michael's gross estate include the proceeds used for his stock redemption. But that is not the case. Treasury regulation § 20.2042-1(c)(6) clarifies that a decedent does not possess the "incidents of ownership" described in § 2042 merely by virtue of being a controlling shareholder in a corporation that owns and benefits from the policy.

Still, although § 2042 does not require that the proceeds be included here, it does not exclude them either. We are cautioned to "[s]ee § 20.2031-2(f) for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock." 26 C.F.R. § 20.2042-1(c)(6). Thus, although the life insurance proceeds intended for redemption do not directly augment Michael's gross estate by way of § 2042, they may well do so indirectly through a proper valuation of Crown. Indeed, the $500,000 of proceeds not used to redeem shares and which simply went into Crown's coffers undisputedly increased Crown's value according to the principles in § 2031 and 26 C.F.R. § 20.2031-2(f)(2).

We must therefore consider the value of the life insurance proceeds intended for redemption insofar as they have not already been taken into account in Crown's valuation and in light of the willing buyer/seller test. In this sense, the parties agree that this case presents the same fair-market-value issue as *Estate of Blount v. Commissioner*, 428 F.3d at 1345-46, from the Eleventh Circuit. But they disagree on whether *Blount* was correctly decided. Like here, *Blount* involved a stock-purchase agreement for a closely held corporation. Although the court referenced the requirement in 26 C.F.R. § 20.2031-2(f)(2) that proceeds be "taken into account," it concluded that the life insurance proceeds had been accounted for by the redemption obligation, which a willing buyer would consider. 428 F.3d at 1345. In balance-sheet terms, the court viewed the life insurance proceeds as an "asset" directly offset by the "liability" to redeem shares, yielding zero effect on the company's value.[5] The court summarized its conclusion with an appeal to the willing buyer/seller concept: "To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value." Id. at 1346.

[5] *Blount* cited favorably the Ninth Circuit's decision in *Estate of Cartwright v. Commissioner*, 183 F.3d 1034, 1038 (9th Cir. 1999), which employed similar reasoning. Like the Eleventh Circuit in *Blount*, the Ninth Circuit's analysis was limited - one paragraph citing 26 C.F.R. § 20.2031-2(f)(2) and the tax-court decision in *Estate of Huntsman v. Commissioner*, 66 T.C. at 875, which merely emphasized that life insurance proceeds are to be considered according to § 20.2031-2(f)(2).

Like the estate in *Blount*, Thomas argues that life insurance proceeds do not augment a company's value where they are offset by a redemption liability. In his view, the money is just passing through and a willing buyer and seller would not account for it. The IRS counters that this assumption defies common sense and customary valuation principles, as reflected in Treasury regulations.

The IRS has the better argument. *Blount*'s flaw lies in its premise. An obligation to redeem shares is not a liability in the ordinary business sense. See 6A Fletcher Cyclopedia of the Law of Corporations § 2859 (Sept. 2022 update) ("The redemption of stock is a reduction of surplus, not the satisfaction of a liability."). Treating it so "distorts the nature of the ownership interest represented by those shares." See Est. of Blount v. Comm'r, 87 T.C.M. (CCH) 1303, 1319 (2004), *aff'd in part and rev'd in part*, 428 F.3d at 1338. Consider the willing buyer at the time of Michael's death. To own Crown outright, the buyer must obtain all its shares. At that point, he could then extinguish the stock-purchase agreement or redeem the shares from himself. This is just like moving money from one pocket to another. There is no liability to be considered - the buyer controls the life insurance proceeds. A buyer of Crown would therefore pay up to $6.86 million, having "taken into account" the life insurance proceeds, and extinguish or redeem as desired. See 26 C.F.R. § 20.2031-2(f)(2). On the flip side, a hypothetical willing seller of Crown holding all 500 shares would not accept only $3.86 million knowing that the company was about to receive $3 million in life insurance proceeds, even if those proceeds were intended to redeem a portion of the seller's own shares. To accept $3.86 million would be to ignore, instead of "take[] into account," the anticipated life insurance proceeds. See *id*.

To further see the illogic of the estate's position, consider the resulting windfall to Thomas. If we accept the estate's view and look to Crown's value exclusive of the life insurance proceeds intended for redemption, then upon Michael's death, each share was worth $7,720 before redemption.[6] After redemption, Michael's interest is extinguished, but Thomas still has 114.1 shares giving him full control of Crown's $3.86 million value. Those shares are now worth about $33,800 each.[7] Overnight and without any material change to the company, Thomas's shares would have quadrupled in value.[8] This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a "liability." A true offset would leave the value of Thomas's shares undisturbed. See Cox & Hazen, supra, § 21:2 ("When a corporation purchases its own stock, it has depleted its assets by whatever amount of money or property it gave in exchange for the stock. There is, however, an increase in the proportional interest of the nonselling shareholders in the remaining assets of the corporation."). In sum, the brothers' arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased shareholders' equity. A fair market value of Michael's shares must account for that reality.

[6] $3.86 million divided by 500 shares.

[7] $3.86 million divided by 114.1 shares.

[8] No one has argued that Michael's death and Thomas's subsequent sole ownership of Crown accounts for such an increase. *Cf. Huntsman*, 66 T.C. at 879 ("The decedent was the dominant force in both businesses, and his untimely death obviously reduced the value of the stock in the two corporations.").

For background on the court's Code § 2042 analysis, see part II.Q.4.i.ii.(b) Corporate Ownership of Policy.

Keeping a pre-1990 agreement outside of the application of Code § 2703 would avoid the statute's imposition of the comparability test. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in a significant change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification that's would subject it to this test.[4638] If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless updating would not have resulted in a substantial modification.[4639] Adding any family member as a party to a right or restriction is a substantial modification unless either the terms of the right or restriction require the addition or the added family member is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction.[4640] However, a substantial modification does not include a modification required by the terms of a right or restriction, a discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction, a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate, or a modification that results in an option price that more closely approximates fair market value.[4641] Amending an agreement to extend the number of years of payment, to clarify that the prime rate is to be established semi-annually, and to update the name of the banking institution from the original bank's name to its successor's name was not a substantial modification.[4642] Issuing nonvoting shares proportionately to the owners of voting stock in an S corporation was not a substantial modification.[4643]

The U.S. Supreme Court, 602 U.S. ___ (2024), affirmed. The Court's unanimous opinion began:

> Michael and Thomas Connelly owned a building supply corporation. The brothers entered into an agreement to ensure that the company would stay in the family if either brother died. Under that agreement, the corporation could be required to redeem (i.e., purchase) the deceased brother's shares. To fund the possible share redemption, the corporation obtained life insurance on each brother. After Michael died, a narrow dispute arose over how to value his shares for calculating the estate tax. The central question is whether the corporation's obligation to redeem Michael's shares was a liability that decreased the value of those shares. We conclude that it was not and therefore affirm.

[4638] Reg. § 25.2703-1(c)(1).
[4639] Reg. § 25.2703-1(c)(1).
[4640] Reg. § 25.2703-1(c)(1).
[4641] Reg. § 25.2703-1(c)(2).
[4642] Letter Ruling 201313001.
[4643] Letter Ruling 201536009, reasoning:

> In this case, the stock split and amendment to the Articles will apply to all of the common shares (whether voting or nonvoting). Because each shareholder will receive c shares for every common share he or she currently holds, the beneficial interests in Company will not be affected by the stock split, amendment, and share dividend.
>
> Likewise, because the number of authorized voting shares will continue to be x, the shareholders' voting rights will remain unchanged.
>
> Consequently, the stock split, amendment to the Articles, and share dividend will not affect the quality, value or timing of any rights under the Articles, and the changes will not be a substantial modification of the Articles for purposes of § 25.2703-1(c). Accordingly, the Articles will remain exempt from the application of chapter 14.

The Court concluded:

> We hold that Crown's contractual obligation to redeem Michael's shares did not diminish the value of those shares.[2] Because redemption obligations are not necessarily liabilities that reduce a corporation's value for purposes of the federal estate tax, we affirm the judgment of the Court of Appeals.
>
> [2] We do not hold that a redemption obligation can never decrease a corporation's value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject Thomas's position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more.

The Court discussed how the Connelly brothers could have avoided this holding:

> For example, the brothers could have used a cross-purchase agreement - an arrangement in which shareholders agree to purchase each other's shares at death and purchase life-insurance policies on each other to fund the agreement. See S. Pratt, Valuing a Business 821 (6th ed. 2022). A cross-purchase agreement would have allowed Thomas to purchase Michael's shares and keep Crown in the family, while avoiding the risk that the insurance proceeds would increase the value of Michael's shares. The proceeds would have gone directly to Thomas - not to Crown. But, every arrangement has its own drawbacks. A cross-purchase agreement would have required each brother to pay the premiums for the insurance policy on the other brother, creating a risk that one of them would be unable to do so.

Given that *Huffman* requires an estate to provide sufficient evidence proving that its buy-sell agreement is comparable to one or more buy-sell agreements, whether Code § 2703 applies to disregard a buy-sell agreement is an issue that the IRS is unlikely to concede without a fight. In light of the Court's advice to consider using a life-insurance funded cross-purchase rather than a life-insurance funded redemption, see part II.Q.4.i Life Insurance LLC, which reduces various cross-purchase risks.

Letter Ruling 202014006, approving certain actions and amendments as not ruining grandfathering from Code § 2703. Facts included:

> As a result of the transfers of shares of Company stock since the Agreement date, Date 1, Company is now owned by Daughters, C, D, and E, six living grandchildren F, G, H, J, K, and L, as well as six GST Trusts created by C on Date 9.
>
> The Board of Directors of Company proposes to cancel all shares of Company common stock held in treasury and to recapitalize Company so that newly issued voting stock in Company can thereafter be primarily held by shareholders who are active in the management of Company. To accomplish this, Company will amend its Articles to increase the number of common shares and to immediately convert each outstanding common share into one share of Class A voting common stock and x shares of Class B nonvoting common stock. After adoption of the foregoing amended capital structure, the Articles and the Agreement will be amended to reflect the common stock split and the addition of the Class B nonvoting common stock (Plan of Recapitalization).

In addition and as indicated above, after approval of the changes to the corporate structure, C, D and E propose to transfer shares of her Class B nonvoting common stock to the GST Trusts created by her on Date 9 (with respect to C) and Date 10 (with respect to each of D and E).

Letter Ruling 202014006 held:

Ruling #1

The individuals and trusts who were parties to the Agreement as of Date 1 are A, B, C, D, E, the Daughters' Trust, and the six Grandchildren's' Trusts (excluding L's Trust). Under § 2651, A and B, as parents and grandparents of the other parties to the Agreement, are assigned to the eldest generation, which will be referred to as the First Generation. C, D and E, as children of A and B, are assigned to the generation immediately below the First Generation and will be referred to as the Second Generation. The Daughters' Trusts are also assigned to the Second Generation because C, D and E are the only current beneficiaries of the Daughters' Trusts. The six Grandchildren's' Trusts (excluding L's Trust) are assigned to the Third Generation, as each trust benefits only a grandchild of A and B.

There are nine transactions or events after October 8, 1990, in which new parties were treated as having been added to the Agreement. The nine events occurred as follows: (i) on Date 3 with the addition of A's estate upon the death of A; (ii) through (vii) through the addition of F, G, H, J, K, and L, on the date each respective Grandchild's Trust distributed shares of Company stock subject to the Agreement to each such Grandchild, outright and free of trust; (viii) on Date 5 with the addition of B's estate upon the death of B, and (ix) on Date 9 when C transferred shares of her Company stock to the GST Trusts C created, each benefiting a niece or nephew of C.

On Date 2, a date after Date 1 but prior to October 8, 1990, A and B created and funded with shares of Company stock a seventh Grandchild's Trust for L (L's Trust), a newly-born descendant. Since L's Trust was not in existence on Date 1, L's Trust was not a party to the Agreement. However, L's Trust was treated as having been added to the Agreement when it received the shares of Company stock from A and B. Pursuant to Paragraph 1 of the Agreement, the gifted shares were subject to the terms of the Agreement and to the obligations of the transferors thereunder and L's Trust was prohibited from transferring such shares except in accordance with the Agreement. Pursuant to Paragraph 8 of the Agreement, the Endorsement appeared on the certificates issued to L's Trust. Accordingly, the addition is mandatory under the terms of the right or restriction within the meaning of § 25.2703-1(c)(1). Further, under § 2651(f)(2), L's Trust is assigned to the same generation as the sole beneficiary, L, a grandchild of A and B. Therefore, L's Trust is assigned to the Third Generation of family members already parties to the Agreement. Accordingly, L's Trust is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction, within the meaning of § 25.2703-1(c).

On Date 3, A died, survived by his spouse, B, and his Daughters, C, D, and E, and his grandchildren. Pursuant to A's will, B, C, D, and E were the beneficiaries of A's estate. Accordingly, pursuant to § 2651(f)(1) and (2), A 's estate was assigned to the Second Generation of shareholders already parties to the Agreement. Accordingly, the addition of A's estate to the Agreement was the addition of a family member of no lower a generational assignment than the family members already party to the Agreement on Date 1.

On Date 4, and subsequently, the trustee of the Grandchildren's Trusts benefiting F, G, H, J, K, and L distributed shares of Company stock subject to the Agreement to the grandchild for whom a Grandchild's Trust was held, outright and free of trust. The foregoing transfers for J, K and L included shares of Company stock received from Grandchild's Trust for I upon I's death. F , G, H, J, K, and L were treated as having been added to the Agreement when shares of Company stock were distributed to them, outright and free of trust. Pursuant to § 2651(f)(2), each Grandchild's Trust was assigned to the same generational assignment as its sole beneficiary, a grandchild of A and B. Therefore, the addition of the beneficiary of each Grandchild's Trust to the Agreement was the addition of a family member of no lower a generational assignment than the individuals already party to the Agreement as of Date 1.

On Date 5, B died, survived by her Daughters, C, D, and E, and her grandchildren. B's estate is treated as a new party to the Agreement. Pursuant to B's will, C, D , and E were the beneficiaries of B's estate. C, D, and E executed partial disclaimers which resulted in F, G, H, I, J, K , and L acquiring beneficial interests in B's estate. Pursuant to § 2651(f)(1) and (2), B 's estate is treated as being assigned to the Third Generation of shareholders. Therefore, the addition of B's estate to the Agreement was the addition of a family member of no lower than the generational assignment of the individuals already party to the Agreement as of Date 1.

On Date 9, C created and funded six GST Trusts with shares of Company stock for the initial benefit of each of her six living nieces and nephews. A niece or nephew of C, each of whom is also a grandchild of A and B, is the sole beneficiary of each GST Trust for and during the lifetime of each such beneficiary. There are no other permissible distributees from any such GST Trust during such time. Therefore, pursuant to § 2651(f)(1), each GST Trust is treated as being assigned to the Third Generation. Accordingly, a transfer of shares of Company stock subjecting the GST Trust to the Agreement is treated as a transfer to a family member of no lower than the generational assignment of the parties already subject to the Agreement on Date 1. The Agreement was adopted before October 8, 1990 and, consequently is exempt from the application of § 2703, provided the Agreement is not substantially modified as set forth in § 25.2703-1(c). No family member which is treated as having been added to the Agreement after October 8, 1990 is assigned to a lower generational assignment than the parties already subject to the Agreement on Date 1. Accordingly, based upon the information submitted and representations made, we conclude that none of the transfers of shares of Company stock subject to the Agreement after October 8, 1990, constitute substantial modifications within the meaning of § 25.2703-1(c). Consequently, the Agreement continues to be grandfathered for purposes of chapter 14.

Ruling #2

On Date 7, a date after October 8, 1990, Company amended the Articles to change its name to the current name. On Date 8, Company amended and restated the Articles. Also on Date 8, Company amended and restated the Bylaws that included administrative changes such as name change, indemnification, and number of members constituting the Board of Directors.

Based upon the facts submitted and representations made, we conclude that none of the amendments to the Articles on Date 7, the amendments and restatement of the Articles on Date 8, and the amendment and restatement of the Bylaws on Date 8 constitute substantial modifications of any right or restriction in the Articles, the Bylaws, or the Agreement within the meaning of § 25.2703-1(c). Consequently, we conclude that the Articles, the Bylaws, and the Agreement continue to be grandfathered for purposes of chapter 14.

Ruling #3

The proposed Plan of Recapitalization includes a stock split of one share of Company common stock into one share of Class A voting common stock and x shares of Class B nonvoting common stock. The Articles and Agreement will be amended to reflect the stock split and the addition of Class B nonvoting common stock to the capital structure. The issuance of the Class B nonvoting common stock does not change the terms and conditions to which the shareholders are already subject. In addition, the beneficial interest in the Company will not be affected by the stock split because each shareholder of common stock will receive x shares of Class B nonvoting common stock for every share of common stock held prior to the recapitalization. Accordingly, we conclude that the recapitalization does not affect the quality, value, or timing of any rights of the parties to the Agreement.

Based upon the facts submitted and representations made, we conclude that the proposed Plan of Recapitalization, the proposed amendments to the Articles and Agreement to reflect the stock split and the addition of Class B nonvoting common stock to the capital structure, and the issuance of Class B nonvoting common stock, will not constitute substantial modifications of the Agreement or the Articles within the meaning of § 25.2703-1(c). Further, we conclude that the proposed Plan of Recapitalization and the proposed amendments, described above, will not cause § 2703 to apply to transfers of shares of Company stock subject to the Agreement, as amended.

Ruling #4

C, D and E propose to transfer shares of Class B nonvoting stock in the Company to the GST Trusts created by each. Each GST Trust is assigned to the Third Generation of family members subject to the Agreement. We concluded under Ruling 1 that the prior transfers by C of shares of Company stock to C's GST Trusts do not cause a substantial modification of the Agreement. We likewise conclude that the proposed transfers of shares of Company stock by C to her GST Trusts do not cause a substantial modification to the Agreement. Similarly, the proposed transfers by D and E of shares of Company stock to D's and E's GST Trusts, respectively, do not cause a substantial modification of the Agreement.

Accordingly, based upon the facts submitted and representations made, we conclude the proposed transfers of shares of Company stock by C, D and E to the GST Trusts created by each will not constitute substantial modifications of the Agreement within the meaning of § 25.2703-1(c). Further, we conclude that the proposed transfers of shares of Company stock by C, D and E to the GST Trusts created by each will not cause § 2703 to apply to the transfer of shares of Company stock subject to the Agreement, as amended.

Letter Rulings 202014007, 202014008, 202014009, and 202014010 are reported to be companion rulings to Letter Ruling 202014006. Letter Rulings 202015004-202015013 also appear to be companion rulings.

BNA Daily Tax Report (4/24/2020) described ten letter rulings:[4644]

> In 10 similar ruling letters, the IRS concluded that certain events occurring after October 8, 1990 (the date defining whether tax code Section 2703 applies), subject to an agreement that "Company" shareholders (individuals and trusts in a family lineage) entered into before that date, don't constitute substantial modifications of the Agreement or other applicable documents within the meaning of Treasury Regulations Section 25.2703-1(c) such that would cause application of these sections. The events are: (rulings 1,2) transfers of Company shares and additions of new parties to the Agreement - including the estates of first-generation individuals (a husband and wife) upon their deaths, and new generation-skipping transfer (GST) tax-exempt trusts for additional or newly born family members none of whom are assigned to a lower generation than those already subject to the Agreement - as well as amendment and restatement of Company's Articles of Incorporation (including name change); consequently grandfathering continues on all the applicable documents for purposes of Chapter 14 (Special Valuation Rules) of the tax code; (ruling 3) proposed amendments to the Articles and Agreement to reflect Company's plan of recapitalization, including a stock split into voting and nonvoting common shares, deemed as not affecting the quality, value, or timing of any rights of the parties to the Agreement; and (ruling 4) proposed transfers of Company shares by second-generation trust beneficiaries to GST trusts for third-generation beneficiaries.

Finally, many of the buy-sell restrictions in partnership agreements are no more restrictive than would otherwise apply under state law, so the application of Code § 2703 would not have a significant impact on the valuation. Yet the IRS makes a big deal of these issues on audit and acts as if some of the cases cited above give it a major advantage. Consider asking the appraiser to expressly state that (s)he is ignoring any provisions in the agreement that are more restrictive than otherwise applicable state law. That way, when the IRS makes a big deal about Code § 2703, one might respond that one has already assumed that Code § 2703 applied, so that issue is off the table.

II.Q.4.i. Life Insurance LLC to Fund Cross-Purchase

Wouldn't it be nice to avoid using a lot of policies, minimize life insurance income tax consequences to owners coming and going,[4645] and keep the life insurance policies in a safer environment? One solution is to place the policies in a limited liability company (LLC) taxed as a partnership. The owners of the business entity also would be the members (owners) of the LLC. A trust company could serve as manager, taking charge of the policies and ensuring that the

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[4644] Letter Rulings 202017001, 202017002, 202017003, 202017004, 202017005, 202017006, 202017011, 202017012, 202017013, 202017014.

[4645] See text accompanying fns. 4386-4388 in part II.Q.4.b.i Transfer for Value Rule Generally regarding certain transfers involving partnerships. Distributions from partnerships generally are tax-free, as described in part II.Q.8.b.i Distribution of Property by a Partnership; and, as described in fn. 5422, a life insurance contract is not targeted by part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). Entering into a partnership is also tax-free generally ; see part II.M.3 Buying into or Forming a Partnership.

proceeds are used as intended. Each owner would have an interest in policies insuring the other partners' lives. I obtained Letter Ruling 200747002, which approved such a strategy.

Before reviewing that, as background consider that Letter Ruling 9309021 involved the following facts:

> A and B are shareholders of Corporation X and Corporation Y (Corporations) and also will be partners in Partnership. A represents that Corporations own life insurance policies (the Policies) on the lives of A and B, the proceeds of which are dedicated to the purchase of common stock under stock purchase agreements of Corporations. A and B plan to form Partnership and thereafter, Corporations will transfer the Policies to Partnership in consideration of payment to Corporations by Partnership of the interpolated reserve value of the Policies at the time of the transfer.
>
> After the transfer, Partnership will own the Policies and will change the beneficiary of the policies from Corporations to itself. Partnership will pay all premiums due on the Policies after the transfers. A represents that the business purpose for the proposed transfer is to facilitate a cross-purchase agreement between A and B for the stock of Corporations in the event of the death of either A or B.
>
> Partnership will be formed under State's Uniform Partnership Act (the Act). The Act provides in part that all partners are jointly liable for all debts and obligations of Partnership. In addition, the partnership agreement provides that the management and authority of Partnership is equally vested in each of the partners. Partnership will engage in the purchase and acquisition of life insurance policies on the lives of its partners. Partnership will have ownership rights in the Policies and will manage a portfolio of insurance policies.

Letter Ruling 9309021 included the following reasoning/conclusions:

> Under the proposed transaction, Partnership will transfer cash to Corporations, the current owners of the Policies, and will receive in exchange ownership of the Policies on the lives of A and B, the insureds. Under section 1.101-1(b)(4) of the regulations, a transfer for 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." Corporations' transfers of the Policies to partnership in exchange for payment of a sum equal to the interpolated reserve value of the Policies is a transfer for valuable consideration under section 101(a)(2) of the Code and section 1.101-1(b)(4) of the regulations.
>
> When the Corporations transfer the Policies to Partnership, the insureds, A and B, are partner of Partnership. Since the insureds are partners in the partnership to which the Policies are transferred, the transfer for valuable consideration of the Policies from Corporation to partnership is covered by section 101(a)(2)(B) of the Code and as such, the exclusion limitation of section 101(a)(2) does not apply….
>
> Provided that the life insurance proceeds are exempt from gross income under section 101(a) of the Code, the proceeds will be reflected in the partner's distributive share under section 702 as tax-exempt income. The partner's basis in their respective partnership interests will increase under section 705(a)(1)(B) due to their distributive shares of tax-exempt income. Under section 731, distributions from a partnership to a partner are generally nontaxable to the extent that any money distributed does not

> exceed the adjusted basis of the partner's interest in the partnership immediately before the distribution. Accordingly, any proceeds of the life insurance policies distributed to A are not taxable to A to the extent that the distribution does not exceed the adjusted basis of A's partnership interest immediately before the distribution.

The Insurance LLC provides security for the owners, facilitates flexibility in making premium payments, and demonstrates a model for reducing the number of policies that must be used in a cross-purchase. Convincing the business owners' parents to set up generation-skipping perpetual trusts to buy real estate used in the business can help the business owners continue to enjoy the business' financial success while moving the business outside of the estate tax system.

For income tax issues generally, see parts II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies. If a life insurance policy owned on a surviving owner receives a new basis when the beneficial owner predeceases the surviving owner,[4646] consider whether this new basis increases the "investment in the contract" and, if not, whether additional steps should be taken to effectuate that increase.[4647]

II.Q.4.i.i. The Facts of Letter Ruling 200747002

The flowcharts in the Appendices A and B illustrate the situation. Appendix A illustrates trusts that were set up. Appendix B explains the Insurance LLC's structure. Appendix C illustrates some creative planning described below.

In this case, an S corporation had three shareholders: Child A (Brother), Child B (Sister), and BA. BA was an unrelated shareholder. Although the ruling does not disclose the percentage ownership, in fact BA owned 5% of the stock, and Brother and Sister owned the rest in roughly equal amounts. The buy-sell agreement was funded by term life insurance policies.

The grantor, parent of Brother and Sister, set up an irrevocable trust, Trust 2A, for Brother ("Brother's Irrevocable Trust"). This was a typical flexible generation-skipping trust. Brother was trustee and could make distributions under an ascertainable standard to Brother and Brother's descendants. Brother also had the power to appoint Brother's Irrevocable Trust's assets at Brother's death to anyone except to Brother, Brother's creditors, Brother's estate or the creditors of Brother's estate. The grantor had allocated GST exemption to Brother's Irrevocable Trust, and Brother's Irrevocable Trust was not subject to the rule against perpetuities. Thus, Brother's Irrevocable Trust provides Brother with flexibility to use its assets during life and pass them to practically anyone at death. The grantor also set up Trust 2B for Sister with similar terms ("Sister's Irrevocable Trust").

Under a buy-sell agreement, Brother would buy Sister's and BA's stock at their deaths. Brother owned policies on their lives to fund this purchase. Brother also had the right to assign Brother's purchase rights and obligations to Brother's Irrevocable Trust or other trusts controlled by Brother. Brother would then transfer these policies to the LLC. Brother and Brother's Irrevocable Trust would contribute premiums to the LLC and receive the right to death benefits from Policies

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[4646] For basis changes when a partner dies, see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. For basis changes on the death of an owner other than the insured, see part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured.

[4647] 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.

on Sister’s and BA’s lives in proportion to the premiums that Brother and Brother’s Irrevocable Trust made these premium contributions. The goal was to maximize Brother’s Irrevocable Trust’s proportion of contributions, because Brother’s Irrevocable Trust and any trusts created under it are excluded from the estate tax system. However, given the uncertainties of cash flow and the impracticality of frequently changing beneficiary designations, being flexible in sharing premiums was important and the LLC’s use of partnership accounting seemed to be the best way to accomplish that. Brother and Sister had virtually identical goals regarding the buy-sell arrangement.

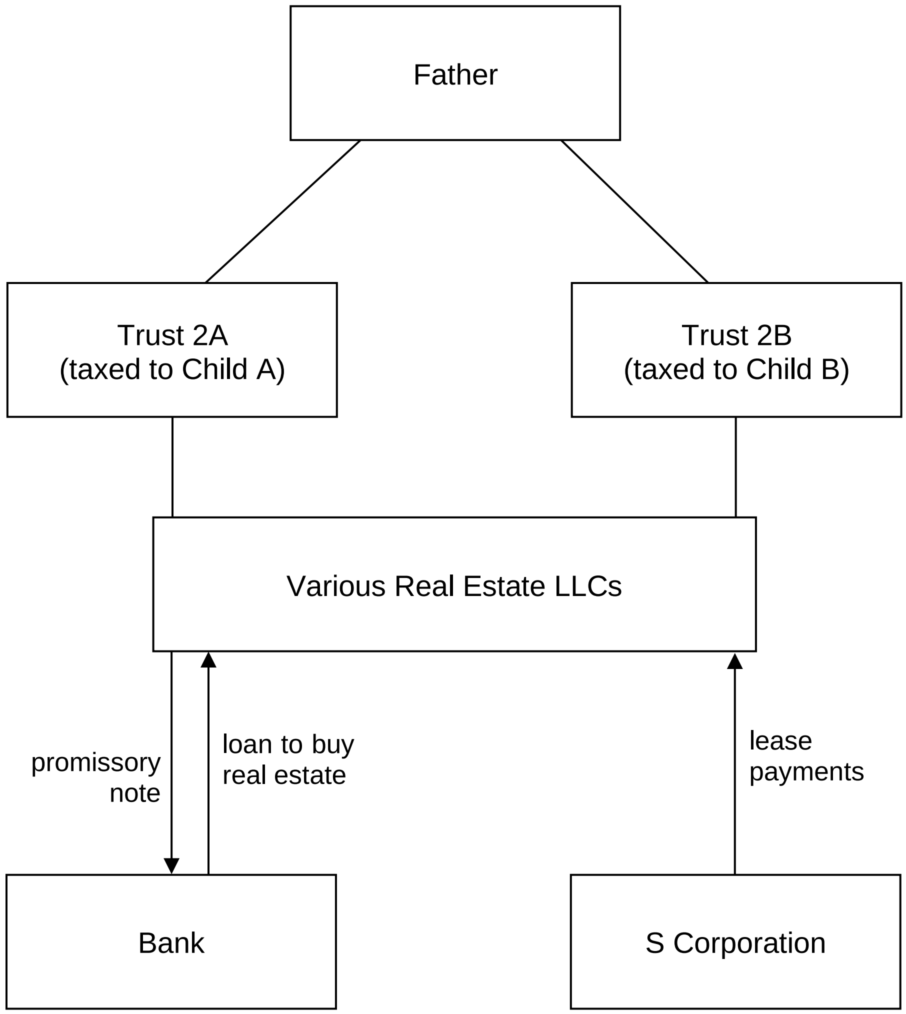
The LLC had some other features. The manager was a corporate trustee. Using a corporate trustee as manager provided security to ensure that no party to the buy-sell agreement would use the life insurance proceeds improperly. The manager was instructed to retain all life insurance proceeds until the parties agreed on their application toward the cross-purchase. Thus, the manager’s roles were essentially the equivalent of a combination of trustee of an irrevocable life insurance trust before a shareholder’s death and escrow agent for the buy-sell agreement after a shareholder’s death.

The LLC’s activity required special partnership accounting provisions. Each member had a separate capital account for each policy the member owned on a shareholder. Also, the members needed to contribute cash to pay the LLC’s administrative expenses, requiring an additional set of capital accounts.

Below are flowcharts illustrating the facts:

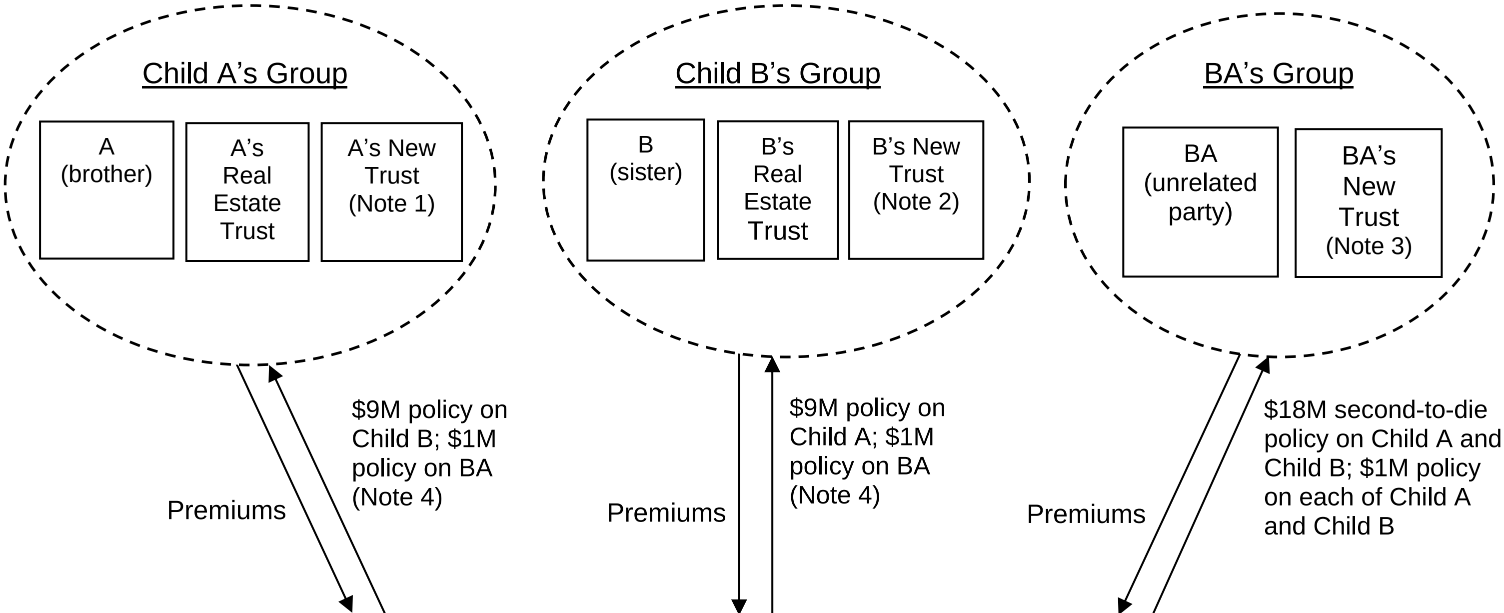
Appendix A

Prior Formation of Trusts



Appendix B

Insurance LLC Structure



Life Insurance LLC – Corporate Trustee, Manager

Each member within a group would have its own separate interest in the LLC's insurance policies, based on its proportionate share of contributions towards premiums on the relevant policy. Purpose of LLC is to secure life insurance proceeds to fund cross-purchase agreement re S Corporation owned by A, B, and BA.

Note 1: Child A would be the grantor and trustee of this irrevocable trust for his spouse's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

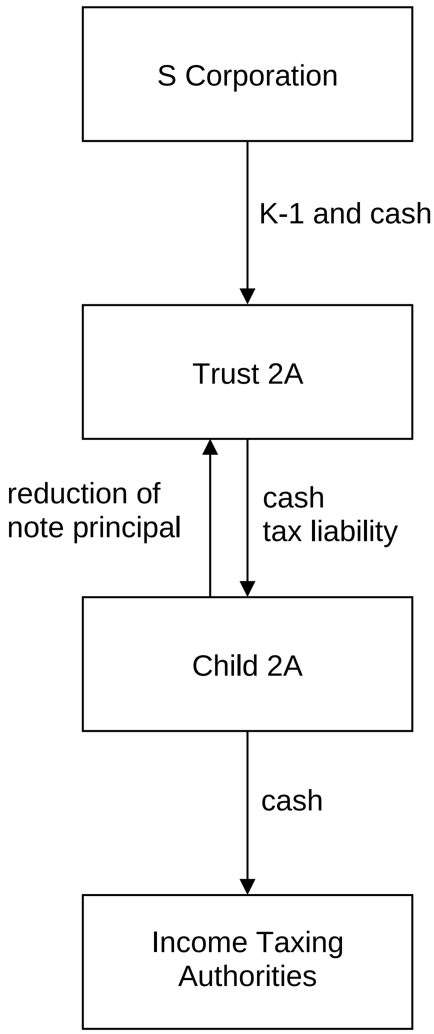
Note 2: Child B would be the grantor and trustee of this irrevocable trust for her descendants' support. (Her children are adults.) Her grandchild would be cut out, but her son could include him.

Note 3: BA would be the grantor and trustee of this irrevocable trust for his wife's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

Note 4: If Child A dies first, Child B's group would become the premium payer with respect to Child A's group's policy on BA's life. If Child B dies first, Child A's group would become the premium payer with respect to Child B's group's policy on BA's life.

Appendix C

Later Sale of S corporation Stock to Irrevocable Grantor Trust



II.Q.4.i.ii. Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity

Code § 2042(2) provides that an insured's gross estate includes the value of all property "to the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person."[4648]

Code § 2035(a) provides:

> If—
>
> (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
>
> (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036 , 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death,
>
> the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

Reg. 20.2042-1(c)(1) begins with:

> Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life not receivable by or for the benefit of the estate if the decedent possessed at the date of his death any of the incidents of ownership in the policy, exercisable either alone or in conjunction with any other person.

Then it continues by pointing out inclusion when incidents of ownership are transferred too soon to death, which is now covered by Code § 2035.

Reg. 20.2042-1(c)(2) provides:

> For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the

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[4648] It continues:

> For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. As used in this paragraph, the term "reversionary interest" includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

> term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. See subparagraph (6) of this paragraph for rules relating to the circumstances under which incidents of ownership held by a corporation are attributable to a decedent through his stock ownership.

Reg. 20.2042-1(c)(3) discusses reversionary interests:

> The term “incidents of ownership” also includes a reversionary interest in the policy or its proceeds, whether arising by the express terms of the policy or other instrument or by operation of law, but only if the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy. As used in this subparagraph, the term “reversionary interest” includes a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him. In order to determine whether or not the value of a reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy, the principles contained in paragraph (c)(3) and (4) of § 20.2037-1, insofar as applicable, shall be followed under this subparagraph. In that connection, there must be specifically taken into consideration any incidents of ownership held by others immediately before the decedent’s death which would affect the value of the reversionary interest. For example, the decedent would not be considered to have a reversionary interest in the policy of a value in excess of 5 percent if the power to obtain the cash surrender value existed in some other person immediately before the decedent’s death and was exercisable by such other person alone and in all events. The terms “reversionary interest” and “incidents of ownership” do not include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or a similar right.

Reg. 20.2042-1(c)(4) is reproduced in part II.Q.4.i.ii.(a) Trust Ownership of Policy.

Reg. 20.2042-1(c)(5) discusses the impact of state law property rights:

> As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the State or other applicable law upon the terms of the policy. For example, assume that the decedent purchased a policy of insurance on his life with funds held by him and his surviving wife as community property, designating their son as beneficiary but retaining the right to surrender the policy. Under the local law, the proceeds upon surrender would have inured to the marital community. Assuming that the policy is not surrendered and that the son receives the proceeds on the decedent’s death, the wife’s transfer of her one-half interest in the policy was not considered absolute before the decedent’s death. Upon the wife’s prior death, one-half of the value of the policy would have been included in her gross estate. Under these circumstances, the power of surrender possessed by the decedent as agent for his wife with respect to one-half of the policy is not, for purposes of this section, an “incident of ownership”, and the decedent is, therefore, deemed to possess an incident of ownership in only one-half of the policy.

Reg. 20.2042-1(c)(6) is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy.

Simple cross-purchase agreements avoid these issues. Rev. Rul. 56-397 ruled that when each of two business associates owns, is the beneficiary of and pays all premiums for an insurance policy on the other business associate, neither of the business associates possesses incidents of ownership in the policy on his or her respective life.

TAM 9349002 asserted incidents of ownership in the following situation:

> On December 31, 1985, the stockholders of the Company entered into the STOCKHOLDERS AGREEMENT, (the "buy-sell agreement") culminating a series of agreements and contracts dated 1980, 1982, 1984, and July 1985. Under the terms of the buy-sell agreement the purchase price of shares purchased pursuant to the agreement was to be determined by a formula increasing the book value of the Company by a weighted income factor. On January 31, 1987, the FIRST AMENDMENT TO STOCKHOLDER'S AGREEMENT modified the applicable date for computation of book value of the Company.
>
> On May 16, 1988, the SECOND AMENDMENT TO STOCKHOLDERS AGREEMENT --
>
> (1) Deleted a right held by B to acquire shares held by Decedent;
>
> (2) Required the Company to redeem Decedent's shares at the end of the 1991 fiscal year (or at any prior date determined by Decedent) unless they had previously been redeemed under the terms of the agreement;
>
> (3) Modified the method of computing book value; and
>
> (4) Made other miscellaneous changes to the buy-sell agreement.
>
> On November 5, 1988, the THIRD AMENDMENT TO SHAREHOLDER'S AGREEMENT was executed. At the time of the third amendment the Decedent held 49.5 percent of the outstanding shares of stock in the Company. While the majority of the remaining shares were held by B, four other employees also held shares in the Company. No single individual held a majority interest in the Company.
>
> After the Third amendment, the buy-sell agreement provided that, if either Decedent or B survived the other by thirty days, the Company stock held by the first to die of Decedent or B would be acquired by the surviving shareholders to the extent insurance proceeds were available. To the extent such proceeds were not available, or if neither survived the other by thirty days, the Company was to redeem the stock. The amount to be paid on the purchase or redemption of the stock was the greater of (1) the amount of insurance proceeds available, or (2) the amount otherwise calculated under the agreement. Any amount in excess of the insurance proceeds was to be paid by the Company over a period of four years pursuant to a promissory note containing the terms set forth in the agreement. Information submitted by the taxpayer indicates that the application of the formula as of June 30, 1989, would have resulted in a promissory note in the amount of $490,000.
>
> The amended buy-sell agreement named a corporate trustee to be the applicant, owner, and beneficiary of policies of insurance on the lives of each of Decedent and B except that the Company was to be the owner to the extent of the each policy's cash surrender value. The trustee was precluded from exercising any powers of ownership by canceling

a policy, assigning ownership, changing the name of the beneficiary, borrowing against a policy, or otherwise changing the nature or value of any policy.

The amended buy-sell agreement provided that, upon termination of tile trust, any unmatured policy was to be transferred to the Company subject to the right of the insured to purchase the policy for the then interpolated terminal reserve (cash surrender value). The trust was to terminate upon the first to occur of --

(1) the death of the first to die of Decedent or B,

(2) the completion of the redemption of Decedent’s shares, or

(3) the completion of the redemption of B’s shares.

Subparagraph 6 (I) of the amended buy-sell agreement provided, in part --

> If [a] redeeming shareholder dies prior to the completion of [the] redemption, the Trustee shall collect the insurance proceeds and ... pay the balance remaining due for said redemption to the deceased Shareholder1s estate and pay the balance of the insurance proceeds pro rata to the remaining Shareholders of record on the date of death. If any Shareholder sells his shares during his lifetime pursuant to the terms of the Agreement or upon termination of this Amendment, such Shareholder(s) shall have the right to purchase the policy or policies upon his life owned by the Trustee, but only after all monies being paid to the redeeming Shareholder have been paid in full. This purchase shall be upon the same terms and conditions as set forth . . . for the purchase of such policy or policies by the surviving shareholder from the corporation.

On February 7, 1989, when Decedent was age 54, the trust acquired an increasing premium term policy of insurance on Decedent’s life ($500,000 face value) using funds furnished by the Company to pay the initial premium on the policy. Under the terms of the policy there would be “no cash values until after insured’s age 71.”

On November 10, 1989, Decedent, and three of the small shareholders entered into a “STOCK PURCHASE AND REDEMPTION AGREEMENT” (the “redemption agreement”) wherein it was agreed that the Company would purchase Decedent’s shares by delivery of a promissory note having a face value of $300,000 payable over a thirty month period. The agreement also provided that Decedent would receive a cash payment of $150,000 at closing in exchange for her covenant not to compete for a period of two years. The agreement, signed by B as President, was contingent on the execution by B of a repurchase agreement with respect to B’s shares in another jointly owned company engaged in a similar line of business. No insurance policies were involved with respect to the repurchase of B’s shares in the other company.

Paragraph 10 of the redemption agreement provides that, after full payment of the promissory note, Decedent would have the right to purchase any company owned policies insuring Decedent’s life at the policies’ then cash surrender value plus the amount of the pro-rated annual premium.

The redemption agreement contains a recital that it supersedes all prior understandings and written agreements specifically including the amended buy-sell agreement. We note

> that one individual holding a small number of shares did not execute the repurchase agreement.
>
> On December 15, 1989, Decedent surrendered her shares to Company in exchange for a promissory note in the amount of $300,000. The note provided for 30 equal monthly payments of principal and interest with the final payment due on June 15, 1992.
>
> Decedent died on September 27, 1991, at age 55 (age 56 as of her nearest birthday) when the balance due under the promissory note was $96,231.47. Upon the death of Decedent the trustee distributed a portion of the insurance proceeds to the estate (in an amount equal to the balance due on the promissory note) and the balance to B and the other shareholders.
>
> The probability that a person aged 56 will survive for a period of nine months exceeds 99 percent.

TAM 9349002 asserted that the above facts supported the following conclusions:

1. At the time the life insurance arrangement was created, the Decedent's stock was to be redeemed by Company within thirty-eight months and that final payment of the promissory note would have occurred within sixty-eight months.

2. The insurance policies were acquired with Company earnings that would otherwise have accrued to the benefit of the shareholders.

3. Neither the Company nor the trustee could exercise any of the incidents of ownership that existed with respect to the insurance policy during the term of the trust (except as directed by the shareholders through modification of the agreement). The "trustee," holding no independent authority, functioned solely as an agent for the shareholders ([sic] accepting and forwarding the premiums on the insurance policies and collecting and disbursing the proceeds, if any, received with respect to each policy.

4. The policy was structured so that its cash surrender value would be zero until several years after the trust terminated. Thus, the Decedent would have been able to acquire the policy by paying the then unexpired (pro-rata) portion of the annual premium regardless of the actual value of the policy at the completion of the redemption.

TAM 9349002 agreed with the estate "that the Decedent did not possess more than 50 percent of the combined voting power of the corporation; thus, the incidents of ownership in the policy held by the Company, if any, are not attributed to the Decedent under the indirect control rationale of section 20.2042-1(c)(6)." However, the IRS disagreed regarding Reg. 20.2042-1(c)(3):

> Taxpayer argues that the Decedent did not have a reversionary interest in the policy immediately prior to death. Taxpayer contends that a reversion cannot exist in property that was never held by the Decedent and, even if it could, no reversion exists in this case because the policy would not have automatically returned to the Decedent.
>
> Taxpayer relies on *Estate of Leder v. Commissioner*, 893 F.2d 237 (10th Cir. 1989), *Estate of Headrick v. Commissioner*, 918 F.2d 1263 (6th Cir. 1990), and *Estate of Perry*

v. Commissioner, 927 F.2d 209 (5th Cir. 1991), for the proposition that Decedent did not "transfer" a policy of insurance on Decedent's life. We believe taxpayer's reliance is misplaced. While those cases did reject a "constructive", (or "beamed") transfer doctrine in the application of section 2035(d)(2), they did not deny the validity of that doctrine.

In *Leder* for example, the court recognized the existence of a transfer, stating, in part:

> The typical example of a constructive transfer is where the decedent purchases a life insurance policy on himself or herself, pays all the premiums, and designates his or her children or spouse as the owners and beneficiaries. In these situations courts construing section 2035(a) view the decedent's actions as acts of transfer, because the decedent "beamed" the policy proceeds to the children or spouse by paying the policy premiums and creating in the children or spouse all of the contractual rights to the insurance benefits. [*Bel*, 452 F.2d 683 (5th Cir. 1971), *cert. denied*, 406 U.S. 919 (1972)].

It is clear that in *Leder*, as in the other cases cited by the taxpayer, the decision did not hinge on whether the insured had transferred a policy of insurance but on the technical issue of whether the insured had transferred an interest in the policy that would have caused inclusion of the proceeds under section 2042 of the Code if the interest had not been transferred. In addition, in those cases the trustee or other third party transferee who purchased the policy ostensibly had a much greater degree of independence in the selection and acquisition of trust assets.

In this case the Decedent, along with the other shareholders, caused the Company to transfer assets to the trustee who was directed to acquire a policy of insurance on the life of each of the two major shareholders. Whether the arrangement is viewed as a transfer of the assets or as an interest free loan, the result is a constructive transfer of an insurance policy.

Similarly, we disagree with the taxpayer's analysis of the Decedent's potential right to re-acquire the policy.

Taxpayer, citing *Estate of Smith*, 73 T.C. 307 (1979), *acq. in result only*, 1981-1 C.B. 2, suggests that no reversion exists if return of the policy is contingent on events over which the insured has no control. We believe the absence of control is relevant only with respect to the VALUE of the insured's right (the PROBABILITY of reverter) and has no relevance with respect to the EXISTENCE of that right (the POSSIBILITY of reverter).

In *Smith* the insured possessed the right to acquire an employer- owned policy only if the employer elected to discontinue the policies either through nonpayment of premiums or by surrender of the policies. At the date of death the contingencies under which the insured could acquire the policy had not occurred and the issue before the court was whether the insured's veto power (over the cancelation of the policies) was a sufficient incident of ownership to cause inclusion in the gross estate.

We do not believe that *Smith* is relevant here. The issue as framed by the court in *Smith* was whether the insured, acting alone or in conjunction with the employer could have exercised any of the incidents of ownership or if the insured could have prevented the exercise by the employer of any incidents of ownership. We can find no discussion as to whether the insured's contingent right to acquire the policies constituted a reversionary interest as contemplated in section 20.2042-1(a)(6) of the regulations. We assume that the issue was not discussed because the value of the insured's possibility of reverter would not have exceeded five percent of the value of the policies immediately before the death of the insured.

Taxpayer further argues that the Decedent possessed no reversionary interest in the policy because her right to acquire the policy was contingent on the final payment of the promissory note, "an event over which [the Decedent] had no control". We can find no indication in the file that the promissory note was not enforceable at the time of the Decedent's death and taxpayer has furnished no information that would suggest that the Decedent could not have required the Company to make the final payment as contemplated therein. If such evidence does exist, we believe it would be relevant solely for purposes of determining the value of Decedent's reversionary interest immediately before the Decedent's death.

Finally, taxpayer argues that no reversion existed because the only way the Decedent could have acquired the policy was to purchase it. Again, we believe that taxpayer raises an issue going to the valuation of the insured's interest rather than the existence of that interest. We note that in this case the purchase price contemplated in the arrangement did not require the Decedent to pay an amount equal to the replacement cost of the policy; *i.e.*, the arrangement did not require the Decedent to pay an amount equal to the cost of a similar policy under the then existent facts.

We would also note that this arrangement did not involve the cross-purchase of life insurance policies. In this case, prior to the redemption, the amended buy-sell agreement essentially created a "winner take all" arrangement. If the Decedent had survived B by more than 30 days, the Decedent would have acquired over ninety percent of the stock in the Company and, thus, would have indirectly owned more than ninety percent of the policy on the her life (with the additional option of acquiring the entire policy).

TAM 9349002 also asserted incidents of ownership under Reg. § 20.2042-1(c)(4):

When the insured cannot initiate the acts associated with the incidents of ownership but can only consent to or veto the exercise of the incidents of ownership by another, the courts have held that the veto power itself constitutes an incident of ownership over the policy. The Second Circuit held that where the insured must consent before the actions of others effectively alter a revocable trust, the insured holds incidents of ownership in a life insurance policy held by the trust. *Estate of Karagheusian v. Commissioner*, 233 F.2d 197 (2d Cir. 1956). Similarly, the Court of Claims held that where the beneficiary/owner of an insurance policy had the power to change the beneficiary, but the power could be exercised only with the consent of the insured, the insured held incidents of ownership in the policy for federal estate tax purposes. *Estate of Goldstein v. United States*, 122 F.Supp 677 (Ct. Cl. 1954). It is immaterial whether the decedent may initiate changes, or whether he must merely consent to them. It is the power and not the substantiality of the power that we must look to. *Schwager v. Commissioner*, 64 T.C. 781 (1975).

Taxpayer argues that the insurance policy at issue was purchased for a valid business purpose and is not, therefore, includible in the insured's gross estate. In support of this position taxpayer cites *Estate of Bert L. Fuchs*, 47 T.C. 199 (1966) and *Estate of*

Howard F. Infante, 29 T.C. Memo 1970-206. Additionally, taxpayer cites *Estate of Smith*, *supra*, and Rev. Rul. 84-130, 1984-2 C.B. 194.

In *Fuchs* the partners agreed to acquire insurance on the lives of the other partners to fund a buy-sell agreement. The partners each acquired insurance on the lives of the other partners pursuant to an agreement which the court characterized as creating an "informal relationship of a quasi-trust nature which obligated the partners to deal with each policy in a manner conforming to the terms of the agreement. Under the "policy facts", the incidents of ownership were vested in the owner. The court stated that any power held by the insured with respect to those incidents was held in a fiduciary capacity similar to that imposed on a trustee.

The facts in *Infante* were similar to those in *Fuchs*, except that the partnership originally acquired the policies, which were then reissued naming each partner absolute owner and beneficiary of the policy on the other partner's life. The court noted that the veto right held by the insured arose from the partnership agreement and as such could only be exercised in conformance with the limitations imposed by the that agreement. Citing *Fuchs*, the court held that the insured did not possess the true incidents of ownership in the policy.

We note that the court in *Infante* recognized that policy facts do not always control and that side agreements can create incidents of ownership. With respect to *Karagheusian*, *supra*., the court stated, in part:

> Decedent had no direct ownership interest in the policy and held none of the powers granted by the terms of the policy itself. His veto power derived exclusively from the trust instrument.
>
> While the "incident of ownership" was created exclusively by the collateral contract (the trust instrument), the contract substantially impinged upon the terms of the policy itself. Through the trust, and in conjunction with his wife, he could have exercised all rights of ownership. In addition, there were no restrictions on the decedent as to the purposes for which he could have used the proceeds of the funds. Hence, through a merely formalistic change of ownership, decedent was able to reserve all rights of ownership without being the owner of record.

The court found the decedent's power to be an "incident of ownership" in the policy for purposes of section 2042(2). In reaching this conclusion, the court analogized the trust situation to the [Estate Tax Regs.] example of indirect ownership of a policy through a corporation as an "incident of ownership" and held that the decedent had obtained an "incident of ownership" (his veto power) through his indirect ownership of the policy.

Rev. Rul. 84-130, 1984-2 C.B. 194, provides that the decedent does not hold incidents of ownership in a group term life insurance policy where the only right the decedent held over a noncontributory group term policy on the decedent's life was the right to convert the policy to an individual policy should the individual cease employment. The ruling notes that the powers mentioned in section 20.2042-1(c)(2) of the regulations are powers that directly affect the insurance policy rather than powers that arise as collateral consequences of independent actions of the insured. As an example of a power exercisable as a result of an independent action and, thus, not an incident of ownership, the ruling cites the power to cancel coverage under a group term policy by terminating employment. See Rev. Rul. 72-307, 1972-1 C.B. 307. The power of cancelation is considered a collateral consequence of the power that every employee holds to terminate employment. See also Rev. Rul. 80-255, 1908-2 C.B. 272.

Both Rev. Rul. 84-130 and *Estate of Smith*, *supra*., involved an employee's rights with respect to employer owned insurance. Neither case involved the insured's rights with respect to a policy of insurance held by a trust created by the insured.

Based on the above we conclude that, under the terms of the amended buy-sell agreement, the Decedent-insured, through her ability to withhold consent to the exercise of the policy rights effectively acquired the incidents of ownership in the life *insurance* policy held by the "trustee". See *Estate of Raragheusian v. Commissioner*, supra. Similarly, because the economic rights with respect to the policy could only be changed by modification of the trust arrangement, and because that arrangement could not be modified without her consent, it seems Clear that the Decedent-insured, in conjunction with the other shareholders, possessed the incidents of ownership in the policy at the date of death.

Analysis of the terms of the amended buy-sell agreement indicates that the duties of the "trustee" thereunder are limited to acquiring the policies of insurance on the lives of B and the Decedent; receiving premium payments from the Company and forwarding those payments to the insuror, and distributing any proceeds paid under the policies to the actual beneficiaries thereof. In as much as the "trustee" was precluded from exercising any of the "powers of ownership" of the policy, it is apparent that the "trustee" acted more as an agent for the shareholders rather than as an independent trustee.

On brief taxpayer has argued that inclusion of the insurance proceeds along with inclusion of the balance on the promissory note would result in double taxation.

In most cases when the issue of double taxation has been before the court, the owner and beneficiary of the insurance policy was the business entity involved. In those cases the question before the court involved indirect ownership of the proceeds through the insured's ownership in the entity.

In this case no portion of the value of the proceeds is indirectly included in the value of the Decedent's gross estate. The fact that the trustee paid a portion of the proceeds to the Company (rather than to the new owners of the Company) would be relevant if the value of the company (as affected by those proceeds) were relevant in determining the value of the Decedent's gross estate.

II.Q.4.i.ii.(a). Trust Ownership of Policy

Reg. § 20.2042-1(c)(4) provides:

A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under section 2036 or 2038 of other property

> transferred by the decedent to the trust if, for example, the decedent has the power to surrender the insurance policy and if the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.

Letter Ruling 9622036 discussed the following scenario:

> You represent that A, B, and C are the shareholders of Corporation X, a “subchapter C” corporation. Shareholder A owns 43 percent of the stock of the corporation; shareholder B owns 14 percent of the stock, and shareholder C owns 43 percent of the stock. Shareholder A is the father of shareholder C. Shareholder B is not related to shareholder A or C.
>
> The corporation and the three shareholders have entered into a stock restriction agreement. It is represented that the agreement was contracted on a bona fide basis for full and adequate consideration. The agreement is legally binding and enforceable against the shareholders and their estates under state law. The agreement provides for the transfer of a shareholder’s corporate stock in the event of the death, disability, retirement, or termination of employment of that shareholder. At a shareholder’s death, the shareholder (or his estate) is obligated to sell, and the surviving shareholders are obligated to buy, his shares at a price specified in the agreement. The agreement requires that the shareholders purchase life insurance on the lives of the other shareholders to ensure payment of the purchase price. The policies that are purchased must be made expressly subject to the agreement. Each shareholder, in signing the agreement, agrees that he will not exercise any of the rights, privileges, or benefits accruing under the policies owned by him and that he will not assign, encumber, borrow against, or otherwise dispose of the policies without the prior written consent of all other shareholders.
>
> Pursuant to the agreement, two life insurance policies have been purchased by the shareholders. Policy 1 is a first-to-die life insurance policy which designates A and C as the insureds and B or his estate as the owner. At the death of the first-to-die of A or C, the survivor of A or C is named the beneficiary of 75 percent of the proceeds of the policy and B is named the beneficiary of the remaining 25 percent.
>
> A second policy, Policy 2, is a life insurance policy on the life of B that is owned by shareholders A and C. Shareholders A and C are each beneficiaries of 50 percent of the proceeds of Policy 2. The premiums on Policies 1 and 2 are paid by the corporation under a collateral assignment split dollar agreement.
>
> Upon the death of a shareholder, the stock restriction agreement requires that the surviving shareholders purchase, on a pro rata basis, such shares of the corporation owned by the decedent as may be purchased for cash with the proceeds of the life insurance policy. The estate of the decedent is obligated to sell such shares. The purchase price under the agreement is to be redetermined annually at the end of each fiscal year by the unanimous agreement of the shareholders. If the shareholders fail to redetermine the value of the shares, the fair market value of the stock is to be determined by an independent certified public accountant. In the event that the insurance proceeds are not sufficient to purchase all of the deceased shareholder’s shares, the corporation is obligated to purchase the balance of the shares. The party that has the obligation to purchase the stock of a deceased shareholder may retain any

> policy proceeds that are in excess of the amount necessary to purchase the stock. The agreement is made expressly binding upon all shareholders and their respective heirs, executors and administrators, successors and assigns.
>
> The shareholders propose to create an irrevocable trust and transfer Policy 1 and Policy 2 to the trust. The trustee of the trust will be a third party unrelated to A, B, or C, and will at no time be a shareholder of the corporation. The trust will be named the beneficiary of the proceeds of each policy and all "policy rights" will be transferred to the trustee of the trust. The "policy rights" include all of the right, title, interest, ownership, control, and incidents of ownership in any and all insurance policies that become subject to the terms of the trust, and in any insurance provided under such policies, together with any additions to such insurance. The "policy rights" are also defined to include any conversion privilege, waiver of premium benefit and accidental death benefit, the right to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy, and the right to assign, pledge, sell or otherwise dispose of any and all right, title, interest, ownership, option, election, privilege, or benefit under the policy.
>
> Upon receipt of any proceeds under either policy, the trustee is obligated to distribute such proceeds to the surviving shareholders who, pursuant to the agreement, are obligated to purchase the decedent's shares. The proceeds are to be distributed in proportion to the percentage of stock held by each surviving shareholder (excluding the stock owned by the deceased shareholder). In the event that a shareholder's shares are purchased by the other shareholders pursuant to the terms of the agreement for any reason other than the shareholder's death, the trustee is obligated to distribute any policy in which the selling shareholder is a named insured to the purchasing shareholders in proportion to the stock ownership of the purchasing shareholders (excluding the shares of stock being purchased from the selling shareholder). In the event of a liquidation of the corporation, the entire trust corpus must be distributed to the shareholders in proportion to their respective percentage stock ownership in the corporation.

Letter Ruling 9622036 ruled that each insured did not hold incidents of ownership:

> In the present case, shareholders A, B, and C, have entered into a binding stock restriction agreement with respect to their corporate stock. The agreement is funded, in part, by a first-to-die life insurance policy, Policy 1, on the lives of shareholders A and C. A portion of the proceeds from Policy 1 is payable to the survivor of A and C, and a portion is payable to B. The beneficiaries must use the policy proceeds to purchase the decedent's stock in the corporation.
>
> The agreement is also funded by a second policy, Policy 2, which insures the life of shareholder B. The proceeds of Policy 2 are payable equally to shareholders A and C. The beneficiaries must use the policy proceeds to purchase the decedent's stock in the corporation.
>
> The shareholders propose to transfer Policy 1 and Policy 2 to an irrevocable trust. The trustee of the trust will be a third party, unrelated to A, B, or C, who will not be a shareholder in the corporation. The trust will be named the beneficiary of the proceeds of each policy and all "policy rights" will be transferred to the trustee of the trust.

We conclude that the proceeds of Policy 1 will not be includible in the gross estate of the first to die of shareholder A or shareholder C under section 2042(2), after the proposed transfer of the policy to the irrevocable trust. Similarly, the proceeds of Policy 2 will not be includible in the gross estate of shareholder B under section 2042(2), after the proposed transfer of the policy to the irrevocable trust.

Zaritsky & Leimberg, ¶7.04. Life Insurance Funding for Buy-Sell Agreements, *Tax Planning with Life Insurance: Analysis With Forms* (WG&L), commented on Letter Ruling 9622036:

The Service ruled that the shareholders did not have incidents of ownership over the policies held by the trust. Although this ruling appears to be favorable, there are several issues that the Service did not address. For example, it is unclear whether one of the shareholders (and which one) must report as taxable income the economic benefit of the policies, since it cannot be known whom the survivor of the father and son will be. In this regard, it is unclear whether 75 percent of the economic benefit should be allocated to or between father and son (the survivor of whom will receive 75 percent of the proceeds) and whether the remaining 25 percent of the economic benefit should be allocated to the unrelated shareholder, who will receive the 25 percent balance of the proceeds. Similarly, it is unclear how the parties should measure the annual economic benefit, as there is no official IRS table for measuring the value of coverage under a first-to-die contract. Furthermore, it is unclear whether there has been a transfer for value, and whether, if neither father nor son reports any annual economic benefit, whether the proceeds payable to the survivor should be subjected to ordinary income tax treatment.

Policy 2 in the ruling was owned by the father and son and insured the life of the unrelated shareholder. When the unrelated shareholder died, the proceeds would be split equally between father and son. The Service could argue that neither father nor son would have allowed the other to be an automatic surviving owner had the other not allowed the same. That reciprocity could provide the consideration required to invoke the transfer-for-value rules. Because of the underlying business reasons for the insurance coverage, it may be difficult to argue that the “transfer” between father and son qualifies under the “gift” exception to the transfer-for-value rule, despite the family relationship. If father and son owned the policy on the unrelated shareholder as tenants-in-common (rather than as joint tenants with rights of survivorship) and one of them died, the decedent’s interest in the policy on the unrelated shareholder’s life would vest in the decedent-policy owner’s estate. It is unclear how the surviving owner would acquire the interest from the deceased’s estate without creating a transfer for value.

The ruling was requested because the shareholders wanted to create an irrevocable trust with an independent trustee and transfer both policies to that trust. The trust is to be the beneficiary of the proceeds of Policy 1 and Policy 2 and also hold all policy rights. The taxpayers’ letter indicated that those policy rights encompass every right that might be considered an incident of ownership. When the trust receives policy proceeds, it must pay out the money to the surviving shareholders who are obligated to buy a decedent’s shares—in proportion to the percentage of stock held by the surviving shareholders (without counting stock owned by the estate of the deceased shareholder).

If a shareholder’s stock were bought on an event other than death, the trustee must distribute the policy on the selling shareholder’s life to the buying shareholders in proportion to their percentage ownership (without counting stock owned by the selling shareholder). If the corporation were liquidated while the shareholders were alive, any policy or other asset in the trust must be distributed to the shareholders in proportion to their respective stock ownership in the corporation. In other words, policy ownership will never revert to the insured. The Service stated that, after the policies are transferred to the trust, the proceeds from Policy 1 and Policy 2 will not be includable in the insured's estate. That favorable outcome was based on the belief that all ownership rights were to be held by the trust, and that there would be no "reversion" of ownership or beneficial interest to the insured. Although it is not totally clear from the facts, it appears that at the death of any shareholder, his interest in the life insurance on the lives of the other shareholders shifts to the surviving shareholder(s). This would be a transfer of an interest in a policy for valuable consideration (*i.e.*, each shareholder tacitly has agreed to allow the interest he owns in a policy to shift to the others in return for their agreement to reciprocate). As noted previously, in the event of a corporate liquidation while all three shareholders are alive, the policies will be distributed in proportion to their respective stock ownership. Were the first-to-die policy to be distributed, father and son (the insureds) would be among the "purchasing" shareholders (together with the unrelated party), and part of the policy will be distributed to father and son, or both. If so, it is unclear what percentage of the assets should be distributed to each of the beneficiaries—in an unsigned document, the decedent could possibly resolve all the potential transfer-for-value problems by making the shareholders legitimate partners in a bona fide partnership, one actually engaged in a business or investment enterprise that meets state and federal law partnership requirements. This brings all three shareholders into a safe harbor exception to the transfer-for-value rule and assures that the life insurance proceeds will be income tax free.

The intent in the arrangement in this ruling was to fund a cross-purchase plan with a minimum number of policies and reduce administration. The ruling seems to bless this approach by stating that neither policy would be includable in the insured's estate. However, planners should consider income as well as estate tax implications. Any transfer for value that were made before the transfer of the policies to the trust would, however, remain, because of the arrangements. Thus, the death proceeds may to be treated as ordinary income taxable to the beneficiaries.

For details on the income issues that concerned Zaritsky & Leimberg, see part II.Q.4.b Transfer for Value Rule; Basis.

Further below are authorities when the insured is a trustee or a beneficiary.

The Official Tax Court Syllabus for *Estate of. Fruehauf v. Commissioner*, 50 T.C. 915 (reviewed 1968), summarized:

Decedent's wife owned several insurance policies taken out on the life of her husband. She died 14 months before her husband. In the wife's will it was provided that the policies were to go to a trust of which decedent was cotrustee and income beneficiary. The trustees were given broad powers to retain policies as long as they desired, to assign some of the policies to obtain money to pay premiums, to designate themselves as beneficiaries, and to sell or convert policies for cash surrender value. Held, the proceeds of the policies were correctly included in decedent's estate and he held incidents of ownership over the policies within sec. 2042, I.R.C. 1954, and the fact that his powers, affecting the beneficiaries' enjoyment of the proceeds, were held by him in his capacity as trustee, was immaterial.

The majority reasoned and held:

> There is no merit in petitioners' argument. The right of the insured or his estate to the economic benefits of the policy is merely one of the several incidents of ownership. The argument advanced by petitioners was rejected in *United States v. Rhode Island Hospital Trust Co.*, 355 F.2d 7 (C.A. 1, 1966), where the court said:
>
>> Plaintiffs seize on Section 20.2042-1(c)(2) of the Treasury Regulations on Estate Tax, which says "… the term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy." Plaintiffs urge that there must be "a real control over the economic benefits". To this there are two answers. First, it is clear that the reference to ownership in the "technical legal sense" is not abandoned and supplanted by reference to "economic benefits". Second, the regulation goes on to list illustrative powers referred to by Congress in its reports. All of these are powers which may or may not enrich decedent's estate, but which can affect the transfer of the policy proceeds…..
>
> In *United States v. Rhode Island Hospital Trust Co.*, *supra*, the court said the relevant question to ask with respect to this statute is: "Did he [decedent] have a capacity to do something to affect the disposition of the policy if he had wanted to?" It cannot be said the capacity to do something to affect the disposition of the policy is lacking merely because it is held in a fiduciary capacity.
>
> It is no answer to say that decedent as trustee owed a duty to the beneficiary to faithfully administer the trust and the beneficiary could have had his actions with respect to the trust corpus reviewed in an action at law or in equity. *Cf. Reinecke v. Smith*, 289 U.S. 172 (1933). As stated in *United States v. Rhode Island Hospital Trust Co.*, *supra*, it is the existence of "powers" that renders the proceeds of the policies taxable as distinguished from the existence of "rights" or duties owed to others.
>
> In the last-cited case, in answer to the same argument with respect to decedent's power over the property being limited because of trustee duties and responsibilities, the court said:
>
>> For decedent had some powers—perhaps not rights, but powers—which could, if exercised alone or in conjunction with another, affect the disposition of some or all of the proceeds of the policy.
>
> There is no doubt at all but that sections 2038 and 2042 are parts of a tax pattern to make includable in the gross estate property over which the decedent held various powers affecting beneficial enjoyment. Since case law makes immaterial for purposes of section 2038 the capacity in which the powers are held, it is not logical to make capacity a significant factor as far as section 2042 is concerned.
>
> In spite of the fact that there is language expressing a contrary view in some of our prior cases, we now hold that the fact the powers over the policies were held by decedent in a fiduciary capacity is no bar to their constituting incidents of ownership under section 2042.

The Sixth Circuit affirmed, 427 F.2d 80 (1970), while disagreeing with the breadth of the Tax Court's reasoning:

> While the opinion of the Tax Court clearly related the holding to the facts of this case, certain language in that opinion is susceptible to interpretation as a broad per se rule that possession by a decedent of powers constituting incidents of ownership in insurance policies on his life, regardless of the capacity in which they are held, always requires inclusion of the proceeds of the policies in the decedent's gross estate. In reasoning to this conclusion the Tax Court placed heavy reliance on a number of cases[2] which arose under § 2038 (and its predecessor sections) of the Code. Section 2038 charges a decedent's gross estate with any property of which he made an inter vivos transfer if, at the date of his death, he possessed the power to "alter, amend, revoke, or terminate" the transfer. The statute also provides that the existence of the power is to be determined "without regard to when or from what source the decedent acquired the power." Thus, the Tax Court reasoned:
>
> > "There is no doubt at all but that sections 2038 and 2042 are parts of a tax pattern to make includable in the gross estate property over which the decedent held various powers affecting beneficial enjoyment. Since case law makes immaterial for purposes of section 2038 the capacity in which the powers are held, it is not logical to make capacity a significant factor as far as section 2042 is concerned."
>
> and held that:
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> > "[T]he fact the powers over the policies were held by decedent in a fiduciary capacity is no bar to their constituting incidents of ownership under section 2042." 50 T.C. at 926.
>
> [2] *E.g.*, *Van Beuren v. McLoughlin*, 262 F.2d 315; (1st Cir. 1958), *cert. denied* (359 U.S. 991 (1959); *Estate of Loughridge v. Commissioner*, 183 F.2d 294 (10th Cir. 1950), *cert. denied*, 340 U.S. 830 (1950); *Union Trust Company of Pittsburgh v. Driscoll*, 138 F.2d 152 (3rd Cir. 1943), *cert. denied*, 321 U.S. 764 (1944); *Welch v. Terhune*, 126 F.2d 695 (1st Cir. 1942).
>
> We must disagree with the Tax Court's broad per se rule. We believe that there is a distinction between the issues arising under § 2038 where the decedent, as transferor of certain property, possesses at his death the power, even though in a fiduciary capacity, to revoke or change the transfer, and the issues in a case arising under § 2042 where the decedent is the transferee, in a fiduciary capacity, of powers constituting incidents of ownership in the insurance policies on his life. Where a decedent holds the requisite powers over policies on his life solely because he is a transferee, in a fiduciary capacity, of those powers, with no beneficial interest therein, such arrangement can hardly be construed as a substitute for testamentary disposition on decedent's part. *Cf. Porter v. Commissioner*, 288 U.S. 436, 444 (1933); *Commissioner v. Chase National Bank*, 82 F.2d 157, 158 (2d Cir. 1936).
>
> Moreover, the Tax Court has previously held that where the decedent himself procured the policies on his life and transferred them to a trust, while retaining certain powers over the policies in a fiduciary capacity, the proceeds of the policies were not includible in the decedent's gross estate. In *Estate of Newcomb Carlton*, 34 T.C. 988 (1960), *rev'd on other grounds*, 298 F.2d 415 (2d Cir. 1962), the decedent originally procured 21

insurance policies on his life. He then transferred them to a trust, together with certain securities, with instructions to use the net income from the securities to pay the premiums on the life insurance policies. The decedent originally retained certain powers over the policies, but by a subsequent instrument he relinquished all rights over the trust except the right to the income from the trust in excess of that necessary to pay the premiums on the life insurance policies, and the right to appoint a co-trustee, including himself, for a co-trustee who had resigned. Decedent never exercised the power to appoint himself as co-trustee, but he retained that power until his death. Had he appointed himself as co-trustee he would have had, in conjunction with the other co-trustees, broad powers to borrow on the insurance policies or surrender them for their cash surrender value, powers which would constitute incidents of ownership in the policies. The Tax Court stated, however:

> "Any control that decedent would have acquired over the insurance policies had he appointed himself co-trustee would have been control over the policies jointly with the corporate trustee as trustee only and such control would be solely for the benefit of the trust. Such control as trustee would not constitute incidents of ownership in the insurance policies in decedent except in his capacity as trustee for the benefit of the trust." 34 T.C. at 996.

In *Estate of Bert L. Fuchs*, 47 T.C. 199 (1966), the decedent was one of three business partners who funded a partnership purchase agreement with insurance policies on the lives of the respective partners. The purchase agreement provided that the beneficiaries would be the owners of the policies, that the beneficiaries would pay the premiums on the policies, and that the insureds would have no right, title or interest in the policies on their respective lives. Through inadvertence on the part of the insurance agent, the policies showed ownership to be in the insured rather than in the beneficiaries, thereby giving the insured the right under the policy to change the beneficiary and to surrender or assign the policies. Nevertheless the Tax Court held that the insured decedent did not possess any incidents of ownership in the policies on his life at the date of his death. While that determination was based on a finding that the insurance policies were subject to the provisions in the partnership purchase agreement, the Tax Court clearly recognized the nature of the fiduciary relationship:

> "Assuming, arguendo, that the insured of each policy herein possessed the naked power to change beneficiaries or make an assignment, we cannot say, in view of the partners' agreement regarding the policies, that the insured herein should be treated in any way differently than a common trustee. Each insured herein was under no less of a legal duty to respect the terms of the partners' agreement than a common trustee legally obligated to respect the terms of a trust indenture. Decedent merely had the same type of power over the ... policies as a trustee's power to affect trust proceeds. We do not believe that this type of naked power alone is sufficient to bring the insurance proceeds within decedent's gross estate." 47 T.C. at 204.

We believe that the Tax Court in this case ignored what it had clearly recognized in these prior cases, *i.e.*, the fundamental nature of the fiduciary relationship. Accordingly, we decline to hold that mere possession by a decedent of any powers in the nature of incidents of ownership in a fiduciary capacity invariably requires inclusion of the proceeds of the policies on the decedent's life in his gross estate.

Our rejection of the per se rule of the Tax Court majority opinion does not dispose of the case, however. In an opinion in which three other judges joined, Judge Simpson of the Tax Court similarly rejected the per se rule of the majority opinion but concurred in the result because of the special facts of this case. Judge Simpson viewed the powers held by decedent in his fiduciary capacity as broad enough to permit their exercise for his individual benefit. Specifically, the concurring opinion concluded that decedent had the power as trustee under paragraph Eighth of his wife's will to surrender the insurance policies for their cash surrender values. The amounts so received could then have been added to the corpus of the trust, thereby increasing the income receivable from the trust by decedent as income beneficiary.

The estate's first response to this analysis of the facts is that decedent did not actually have any powers as trustee or any right to receive any increased income which would result from a surrender of the insurance policies because, at the date of his death, no distribution of assets had been made to the trust, and neither decedent nor any of the other co-trustees had been formally appointed as trustees of the testamentary trust by the state probate court. In support of this argument the estate contends that the normal period for the administration of decedents' estates in Michigan is eighteen months, and since decedent's death here occurred only fourteen months after his wife's death the testamentary trust could not reasonably have been created.

It appears, however, that eighteen months is the maximum period allowable by a Michigan probate court for the administration of an estate before the accrual of interest on pecuniary bequests begins. See *In re Howlett's Estate*, 275 Mich. 596, 602, 267 N.W. 743, 745 (1936). It does not appear that swifter administration of an estate is impossible. Decedent here had the power to become both trustee and life income beneficiary of the testamentary trust through the exercise of his powers as executor of the will. We believe that it is the existence of that power, not its exercise, which is determinative. Merely because decedent had not performed certain acts necessary to enable him to become trustee-beneficiary of the trust does not detract from his power to do so. Moreover, under the terms of paragraph Eighth of his wife's will decedent had the power in his capacity as executor as well as trustee to surrender the policies for their cash value. Accordingly, he could have surrendered the policies for their cash value while he was executor thereby enlarging the income producing ability of the corpus available for distribution in due course to the testamentary trust. We therefore do not consider it significant that decedent had not been formally appointed trustee by the probate court.

The estate's second line of argument is that the fiduciary duty of loyalty imposed upon decedent in his capacity as executor and trustee would have prevented him from exercising any of the powers granted to him in any manner which would benefit himself to the detriment of the remainderman; that any powers granted to decedent which would appear to give him authority to perform acts which would benefit himself to the detriment of the remainderman were void as a matter of law.

It is a well-established rule of law that a fiduciary cannot use his position to benefit himself in his individual capacity. See *e.g.*, *Michigan Trust Co. v. Luton*, 267 Mich. 547, 554, 255 N.W. 351, 353-54 (1934); *Chambers v. Chambers*, 207 Mich. 129, 136, 173 N.W. 367, 369-70 (1919); *Sloan v. Silberstein*, 2 Mich. App. 660, 673, 141 N.W.2d 332, 338 (1966); Bogert, *Trusts and Trustees* § 129 (2d ed. 1965); II *Scott on Trusts* § 170.23 (3rd ed. 1967). There is, however, an equally well established countervailing rule of law that a fiduciary may be authorized by the terms of the instrument creating his powers to

> do that which in the absence of such provision would be a violation of his fiduciary duty of loyalty. II *Scott on Trusts* § 170.9 (3rd ed. 1967). Michigan courts have recognized this rule. See *Waddell v. Waddell*, 335 Mich. 498, 506-7, 56 N.W.2d 257, 260-61 (1953).
>
> Under the provisions of paragraph Eighth of decedent's wife's will, decedent was authorized, both as executor and as trustee, to surrender the policies on his life for their cash value. If this had been done the policies would have been transformed from non-income producing assets designed to benefit primarily the ultimate beneficiary of the trust into income producing assets (since it must be assumed that such proceeds would not remain idle), which would benefit decedent when he assumed his capacity as trustee and income beneficiary of the trust. We must therefore hold that under the facts of this case decedent could exercise powers in the nature of incidents of ownership in the policies to his individual benefit, and that therefore the proceeds of the policies were includible in his gross estate.

Does being the trustee of a trust containing an insurance policy on the trustee's life, with the trustee having no beneficial interest in the trust, result in estate tax inclusion under Code § 2042? *Estate of Skifter v. Commissioner*, 468 F. 2d 699 (2d Cir. 1972) held that the insured as trustee would not have an includable incident of ownership unless the insured had transferred the policy to the trust, implying this requirement into the regulation, which otherwise would not have complied with the statute:

> Although this legislative history is hardly conclusive on the matter, we feel that there is sufficient support to justify our conclusion that Congress intended § 2042 to parallel the statutory scheme governing the interests and powers that will cause other types of property to be included in a decedent's estate. This conclusion is reinforced by the types of interests and powers that Congress indicated were exemplary of what it meant to be included within the scope of "incidents of ownership." The interests there listed are interests that would cause other types of property to be included in a decedent's estate under § 2036 or § 2037; and the powers that Congress discussed are also powers that would result in the property being included in the decedent's estate under § 2038 or § 2041.[4649] Therefore, in ruling on the Commissioner's contention that the fiduciary power here involved is an "incident of ownership," a question that has not been considered under § 2042, we feel that we should look to the experience under the statutory scheme governing the application of the estate tax to other types of property. Indeed, the Commissioner, in making his contention before us, relies on numerous analogies to decisions under these other statutory provisions.
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> The core of the controversy here centers on the decedent's power, as trustee, to prefer the current income beneficiary over the remainderman and all later income beneficiaries through payment of the entire trust corpus. He did not have the power to alter or revoke the trust for his own benefit and he could not name new, additional, or alternative beneficiaries. In this regard, Reg. § 20.2042-1(c)(4) provides:
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>> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or

[4649] [my footnote:] See parts III.C.3 Whether Code § 2036 Applies, III.D Code § 2038, and II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap, the latter of which covers Code § 2041. Code § 2038 cases often cite *Skifter*.

> otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The Commissioner contends that this regulation requires that the proceeds of the policies here be included in decedent's estate.

The Tax Court declined to interpret that regulation so as to make it applicable here, but concluded that, since the power could not be exercised to benefit the decedent or his estate, it would not cause the proceeds to be included in his estate. If the power had been exercisable for the benefit of decedent, or for the benefit of whomever the decedent selected, it would have been necessary to include the proceeds in the estate; for there would be a powerful argument that this was an incident of ownership since he would have had the equivalent of a power of appointment, which under § 2041 would cause other types of property to be included in the estate of the holder of such a power. This distinction causes us to concur in the Tax Court's conclusion that the Commissioner's reliance on our decision in *Commissioner v. Karagheusian's Estate*, 233 F.2d 197 (2d Cir. 1956), is misplaced.

The power that the decedent possessed was over the entire trust corpus, which included property other than the insurance policies. But there is no serious doubt that this power did not result in this other property being in decedent's estate for tax purposes. This type of power would fall under both § 2036 and § 2038. The former provision is clearly not triggered in this case because it only applies to a power retained by the grantor over the income from property when he transferred it to another. Thus, for purposes of § 2036, it would not matter that the decedent effectively had the power to deprive later income beneficiaries of the income from the corpus in favor of an earlier income beneficiary. However, the latter provision, § 2038, would apply because decedent had the power "to alter, amend ..., or terminate" the trust. The Commissioner has pointed to many cases holding that such a power would result in the property interest over which the power could be exercised being included in the estate of the holder of the power. See *e.g. Lober v. United States*, 346 U.S. 335 (1953); *United States v. O'Malley*, 383 U.S. 627 (1966) (decided under § 2036); *Commissioner v. Newbold's Estate*, 158 F.2d 694 (2d Cir. 1946). Therefore, he argues, this power must be an incident of ownership for § 2042 purposes also.

But the Commissioner's reliance on § 2038 cases exposes the fatal flaw in his position. The cases he cites dealt with powers that were retained by the transferor or settlor of a trust. That is not what we have here; the power the decedent had was given to him long after he had divested himself of all interest in the policies—it was not reserved by him at the time of the transfer. This difference between powers retained by a decedent and powers that devolved upon him at a time subsequent to the assignment is not merely formal, but has considerable substance. A taxpayer planning the disposition of his estate can select the powers that he reserves and those that he transfers in order to implement an overall scheme of testamentary disposition; however, a trustee, unless there is agreement by the settlor and/or beneficiaries, can only act within the powers he is granted. When the decedent is the transferee of such a power and holds it in a fiduciary capacity, with no beneficial interest therein, it is difficult to construe this arrangement as a substitute for a testamentary disposition by the decedent. *Cf. Porter v. Commissioner*, 288 U.S. 436, 444 (1933); *Commissioner v. Chase National Bank*, 82 F.2d 157, 158 (2d Cir. 1936).

Accordingly, we conclude that, although such a power might well constitute an incident of ownership if retained by the assignor of the policies, it is not an incident of ownership within the intended scope of § 2042, when it has been conveyed to the decedent long after he had divested himself of all interest in the policies and when he cannot exercise the power for his own benefit. We justify this interpretation of "incidents of ownership" on the apparent intent of Congress that § 2042 was not to operate in such a manner as to discriminate against life insurance, with regard to estate tax treatment, as compared with other types of property. We also note that our conclusion comports with the views expressed by the Sixth Circuit in *Estate of Fruehauf v. Commissioner*, 427 F.2d 80, 84-85 (6th Cir. 1970). Therefore, we must reject the contention of the Commissioner that the language of § 2042 requires that it be given a broader scope of operation than the statutes covering other types of property.

Until now, the discussion has assumed that § 2038 only applies when the power possessed by the decedent was reserved by him at the time he divested himself of all interest in the property (other than life insurance) subject to the power. This necessitates a brief discussion of the language of § 2038, which provides in pertinent part:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer ..., by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) ... *without regard to when or from what source the decedent acquired such power*), to alter, amend, revoke, or terminate ... (emphasis added).

The emphasized language would appear to indicate that § 2038 would apply even when the power was acquired under circumstances such as are present here. However, there is no indication that the Commissioner has ever made such an argument and we have been able to find no case applying § 2038 in this manner.

The noted language was added to the predecessor of § 2038 in 1936 in response to the decision in *White v. Poor*, 296 U.S. 98 (1935). In that case, the decedent had created an inter vivos trust and conferred on the trustee the power jointly to terminate the trust. Subsequently, the decedent was appointed a successor trustee. Therefore, at death decedent possessed this power to terminate and the Commissioner attempted to apply the predecessor to § 2038; but the Supreme Court held this was impermissible because decedent had not retained the power at the time of transfer but had received it later. It was for the purpose of changing this result that Congress added the emphasized language. However, this language appears never to have been applied to a power other than one that the decedent created at the time of transfer in someone else and that later devolved upon him before his death. In essence, the language has been applied strictly to change the result in *White v. Poor*.

We need not here consider the reasons for applying § 2038 to powers such as that involved in *White v. Poor*. Nor need we speculate whether or not such a power would trigger § 2042, for that question is not before us. What is significant for our purposes is that § 2038 has not been applied when the power possessed by decedent was created and conferred on him by someone else long after he had divested himself of all interest in the property subject to the power. Therefore, because of our view that Congress did not intend § 2042 to produce divergent estate tax treatment between life insurance and other types of property, we conclude that the fiduciary power that Skifter possessed at

> his death did not constitute an "incident of ownership" under § 2042; hence, that provision does not require that the life insurance proceeds at issue be included in Skifter's estate.
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> The Tax Court was thus correct in holding that Reg. § 20.2042-1(a)(4) must be read to apply to "reservations of powers by the transferor as trustee" and not to powers such as that in issue. Accordingly, the decision of the Tax Court is affirmed.

GCM 39317 followed *Skifter*. However, *Rose v. U.S.*, 511 F.2d 259 (5th Cir. 1975) held that there was no transfer requirement.

Rev. Rul. 84-179 reasoned:

> The legislative history of section 2042 indicates that Congress intended section 2042 to parallel the statutory scheme governing those powers that would cause other types of property to be included in a decedent's gross estate under other Code sections, particularly sections 2036 and 2038. S. Rep. No. 1622, 83rd Cong., 2d Sess. 124 (1954). See *Estate of Skifter v. Commissioner*, 468 F. 2d 699 (2d Cir. 1972).
>
> Sections 2036(a)(2) and 2038(a)(1) concern lifetime transfers made by the decedent. Under these sections, it is the decedent's power to affect the beneficial interests in, or enjoyment of, the transferred property that required inclusion of the property in the gross estate. Section 2036 is directed at those powers retained by the decedent in connection with the transfer. See, for example, *United States v. O'Malley*, 383 U.S. 627 (1966), 1966-2 C.B. 526. Section 2038(a)(1) is directed at situations where the transferor-decedent sets the machinery in motion that purposefully allows fiduciary powers over the property interest to subsequently return to the transferor-decedent, such as by an incomplete transfer. See *Estate of Reed v. United States*, Civil No. 74-543 (M.D. Fla., May 7, 1975); *Estate of Skifter v. Commissioner*, above cited, at 703-05.
>
> In accordance with the legislative history of section 2042(2), a decedent will not be deemed to have incidents of ownership over an insurance policy on decedent's life where decedent's powers are held in a fiduciary capacity, and are not exercisable for decedent's personal benefit, where the decedent did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the powers on decedent was not part of a prearranged plan involving the participation of decedent. This position is consistent with decisions by several courts of appeal. See *Estate of Skifter*; *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970); *Hunter v. United States*, 624 F.2d 833 (8th Cir. 1980). But see *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975), which are to the contrary. Section 20.2042-1(c)(4) will be read in accordance with the position adopted herein.
>
> The decedent will be deemed to have incidents of ownership over an insurance policy on the decedent's life where decedent's powers are held in a fiduciary capacity and the decedent has transferred the policy or any of the consideration for purchasing and maintaining the policy to the trust. Also, where the decedent's powers could have been exercised for decedent's benefit, they will constitute incidents of ownership in the policy, without regard to how those powers were acquired and without consideration of whether the decedent transferred to property to the trust. *Estate of Fruehauf*; *Estate of Skifter*, above cited at 703. Thus, if the decedent reacquires powers over insurance policies in

> an individual capacity, the powers will constitute incidents of ownership even though the decedent is a transferee.
>
> In the present situation, D completely relinquished all interest in the insurance policy on D's life. The powers over the policy devolved on D as a fiduciary, through an independent transaction, and were not exercisable for D's own benefit. Also, D did not transfer property to the trust. Thus, D did not possess incidents of ownership over the policy for purposes of section 2042(2) of the Code.

Rev. Rul. 84-179 held:

> An insured decedent who transferred all incidents of ownership in a policy to another person, who in an unrelated transaction transferred powers over the policy in trust to the decedent, will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2) of the Code, provided that the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for personal benefit. The result is the same where the decedent, as trustee, purchased the policy with trust assets, did not contribute assets to the trust or maintain the policy with personal assets, and could not exercise the powers for personal benefit.

Citing Rev. Rul. 84-179 with approval, Letter Ruling 9602010 reasoned and held:

> In the present case, the Indenture of Trust vests the trustees of the separate trusts with all rights, title, and interest in and to the policies and prohibits the trustees from distributing any portion of a life insurance policy or its proceeds to the insured daughter. In addition, neither A nor B can serve as a trustee under the Indenture of Trust. Therefore, we need not address specifically the problems concerning the application of 2042(2) where the insured holds powers over the life insurance policies in a fiduciary capacity. Instead, we must consider A and B's powers over the maintenance and distribution of the assets held in their separate trusts. The ability to control these assets may indirectly give A and B or their estates powers over the economic benefits of the life insurance policies.
>
> Although A and B are the income beneficiaries of their respective separate trusts and each has the right to receive distributions of principal, their rights to distributions of principal are subject to the trustees absolute discretion. Neither A nor B can direct corpus to be distributed to themselves.
>
> Under the Indenture of Trusts, the separate trusts were created by A and B's father. The annual premiums on the life insurance policies will be paid from the principal of the separate trusts. Neither A nor B can transfer assets to their separate trusts. Therefore, neither A nor B can maintain any life insurance policies held by their separate trusts with personal assets.
>
> Although both A and B have special powers of appointment to cause the trustees of their separate trusts to distribute principal of their separate trusts to such beneficiaries (other than the daughter, her creditors, her estate, or the creditors of her estate) as they designate, these powers of appointment are effective only when there are no life insurance policies on the life of the beneficiary included in trust assets. Generally, an inter vivos exercise of a special power of appointment could reduce the principal of a trust so that there are insufficient funds to pay the premiums on the life insurance

policies. In addition, a testamentary exercise of a special power of appointment could result in a reversionary interest in the life insurance policies. In this case, the special powers of appointment are not effective when insurance policies on the life of the beneficiary-daughter are among trust assets. Therefore, A and B cannot exercise their special powers of appointment to gain any economic benefits of the life insurance policies.

Based on the facts and representations made in your request for rulings and your subsequent submissions, we conclude that neither A nor B will possess any incidents of ownership over life insurance policies on their lives held by the trustees of their irrevocable trusts and that the proceeds of the policies will not be includible in their gross estates under section 2042(2).

We express no opinion at this time with respect to the gift tax consequences to A or B where the trustees of their separate trusts invest in a nonincome-producing life insurance policy on their lives.

Letter Ruling 9111028 involved the following facts:

A is a trustee of the Trust. The Trust, a family trust, was originally part of a revocable trust, which, on B's death, was divided into the Trust and a marital trust. The trustee of the Trust is to pay to or apply for the benefit of A (B's surviving spouse) and B's descendants as much of the net income and principal of the Trust as the trustee deems necessary or advisable for their education, health, maintenance, and support, provided that no distribution to the descendants will operate to discharge or relieve A of any legal support obligation. Any income not distributed is accumulated and added to principal. Distributions of principal from the Trust to A are to be made only after exhaustion of the marital trust principal.

A has a limited power to appoint, at any time, all or any portion of the principal of the Trust, other than any insurance policy on her life, to or for the benefit of B's descendants, in such amounts and proportions, and terms as A may elect. A may remove a trustee without reason by written notice at any time.

The Trust provides that any trustee with an interest in the trust is excluded from decisions to distribute income or principal to such trustee except as limited by an ascertainable standard. In addition, the trustee is excluded from making any decisions with respect to distributions to any person the trustee is legally obligated to support. Any individual trustee whose life is insured by a policy held as trust property is prohibited from exercising any power conferred on the owner of such policy.

Letter Ruling 9111028 reasoned and held:

In the present case, distributions of income and principal of the Trust can only be made to A or B's descendants when the trustees deem it necessary or advisable for their education, health, maintenance, and support. A, as a trustee whose life is insured by a policy held by the Trust, is specifically prohibited from exercising any power normally conferred on the owner of a policy. In addition, although A has a special power of appointment over the Trust principal, any insurance policies on A's life are specifically excluded from the scope of that power. Therefore, A does not possess any incidents of

> ownership over the policies on A's life held by the Trust that would cause inclusion of the policies in A's gross estate at A's death.

Letter Ruling 9434028 involved the following facts:

> You represent that, in 1975, the taxpayer's father created an irrevocable trust for the benefit of the taxpayer. The taxpayer is the life income beneficiary of the Trust and is currently serving as trustee. As trustee, she may also distribute principal to herself under an ascertainable standard relating to her maintenance. During the taxpayer's lifetime, she has the power to appoint all or any portion of the Trust principal to, or for the benefit of any one or more of her issue. Upon her death, the Trust assets will be distributed to her issue, per stirpes. Under the laws of the state in which the Trust was created, the powers granted to the trustee of the Trust include the power to invest and reinvest, as the fiduciary deems advisable, in insurance contracts on the life of any beneficiary or of any person in whom a beneficiary has an insurable interest, and generally in such property as the fiduciary shall deem advisable, even though such investment shall not be of the character approved by applicable law but for this provision.
>
> The taxpayer proposes to resign as trustee of the Trust. The terms of the Trust provide for a specified successor third-party trustee if the trustee should resign or fail to serve for any reason. If this third-party trustee should fail to serve, a corporate bank is named as trustee. You represent that the successor trustee proposes to purchase a life insurance policy on the life of the taxpayer. It is represented that the annual premium on the policy will be paid from Trust principal. On the taxpayer's death, the insurance proceeds will be paid to the Trust and will be allocated to principal, which will be distributed as set forth in the trust instrument.

Letter Ruling 9434028 reasoned and held:

> In the present case, the taxpayer is currently trustee and income beneficiary of the Trust and has the right to receive discretionary distributions of corpus for her maintenance. The taxpayer proposes to resign as trustee of the Trust. A third-party named in the Trust instrument will become successor trustee. It is represented that the successor trustee, after being named trustee, proposes to purchase a life insurance policy on the life of the taxpayer. The Trust was created and funded by the taxpayer's father during his lifetime and the taxpayer has not transferred any assets to the Trust. The annual premiums on the policy will be paid from the principal of the Trust and the taxpayer will not maintain the policy with personal assets.
>
> We express no opinion at this time with respect to the gift tax consequences to the taxpayer/income beneficiary where the trustee invests in a nonincome-producing life insurance policy on the taxpayer's life.
>
> We conclude that the taxpayer will not possess incidents of ownership over a life insurance policy on her life that is purchased by the successor trustee of an irrevocable trust where the taxpayer is the former trustee. Therefore, the proceeds of the policy will not be includible in the taxpayer's gross estate at her death under section 2042(2), assuming that the taxpayer is not reinstated as trustee and serving in that capacity at the time of her death or, after being reinstated, subsequently resigns as trustee within three years of her death. See *Estate of Fruehauf* and Rev. Rul. 84-179.

Letter Ruling 9602010 involved the following facts:

> The Grantor proposes to execute an Indenture of Trust. Under the Indenture of Trust, the Grantor will establish two separate irrevocable trusts, one for the benefit of each of his two daughters, A and B. Under the terms of the Indenture of Trust, trust assets include the property listed in “Schedule A” of the Indenture of Trust. In addition, the trustees shall accept any other property which may be transferred to them by the Grantor or others by will or other instrument. Neither the Grantor nor his daughters may serve as trustees.
>
> During each daughter’s lifetime, the net income of her separate trust is to be distributed to the daughter in convenient periodic installments. The trustees, also, may distribute to each daughter principal of their separate trust. The amount of principal distributable is the amount the trustees, in their absolute discretion, deem advisable and is not limited otherwise.
>
> Generally, during a daughter’s lifetime, the trustees must distribute principal of the daughter’s separate trust to any beneficiary (other than the daughter, her creditors, her estate, or the creditors of her estate) the daughter designates in writing. This power of appointment, however, is not effective if the daughter’s separate trust holds any insurance policies on the life of the daughter.
>
> Upon a daughter’s death, the balance of the principal of the daughter’s separate trust is distributable to any beneficiary (other than the daughter, her creditors, her estate, or the creditors of her estate) the daughter appoints by will or other written instrument delivered to the trustees during her lifetime. This power of appointment, however, is not effective if, at the time of the daughter’s death or immediately prior to her death, the daughter’s separate trust holds any insurance policies on the life of the daughter.
>
> To the extent that a daughter fails to exercise her power of appointment or cannot exercise her power of appointment prior to or upon her death, the remaining principal of her separate trust will be distributed to her issue then living, per stirpes. If there is no such issue, the trust assets shall be divided among the Grantor’s issue then living, per stirpes. Any share attributable to A or B shall be added to such daughter’s separate trust established under the Indenture of Trust. In the case of a share attributable to a child of the Grantor born subsequent to the date of the Indenture of Trust, that child’s share shall be added to a trust established under another indenture of trust with terms identical to the terms in the Indenture of Trust. Each share attributable to a grandchild of the grantor shall be held in a separate trust for the benefit of such grandchild.
>
> Section VI of the Indenture of Trust gives the trustees of each separate trust the power to purchase life insurance policies on the life of the beneficiary of the separate trust. In addition, section VII indicates that life insurance policies may be among the assets transferred to the separate trusts. Under section VII of the Indenture of Trust, the trustees are vested with all rights, title, and interest in and to the policies. In addition, the trustees of each separate trust may not distribute to the beneficiary all or any portion of a policy of insurance on the life of the beneficiary.
>
> It is represented that the annual premiums on any life insurance policies on the life of the beneficiaries will be paid from principal of the separate trusts. On the death of A or B, the insurance proceeds of the life insurance policies will be paid to their respective separate

trust and will be allocated to principal, which will be distributed as set forth in the trust instrument.

Letter Ruling 9602010 reasoned and held:

> Under the facts presented in the ruling, the decedent transferred the policy to the spouse and subsequently, in an unrelated transaction, reacquired incidents of ownership over the policy in a fiduciary capacity. The ruling holds that under these circumstances, the decedent will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2), provided the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for the decedent's personal benefit. The ruling further provides that the result would be the same if the decedent acting as trustee purchased a policy as a trust asset. The ruling states, however, that where the decedent's powers over the policy could have been exercised for the decedent's benefit, they would constitute incidents of ownership in the policy without regard to how those powers were acquired and without consideration of whether or not the decedent was the source of the funds used to pay the premiums. See *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970).
>
> In the present case, the Indenture of Trust vests the trustees of the separate trusts with all rights, title, and interest in and to the policies and prohibits the trustees from distributing any portion of a life insurance policy or its proceeds to the insured daughter. In addition, neither A nor B can serve as a trustee under the Indenture of Trust. Therefore, we need not address specifically the problems concerning the application of 2042(2) where the insured holds powers over the life insurance policies in a fiduciary capacity. Instead, we must consider A and B's powers over the maintenance and distribution of the assets held in their separate trusts. The ability to control these assets may indirectly give A and B or their estates powers over the economic benefits of the life insurance policies.
>
> Although A and B are the income beneficiaries of their respective separate trusts and each has the right to receive distributions of principal, their rights to distributions of principal are subject to the trustees absolute discretion. Neither A nor B can direct corpus to be distributed to themselves.
>
> Under the Indenture of Trusts, the separate trusts were created by A and B's father. The annual premiums on the life insurance policies will be paid from the principal of the separate trusts. Neither A nor B can transfer assets to their separate trusts. Therefore, neither A nor B can maintain any life insurance policies held by their separate trusts with personal assets.
>
> Although both A and B have special powers of appointment to cause the trustees of their separate trusts to distribute principal of their separate trusts to such beneficiaries (other than the daughter, her creditors, her estate, or the creditors of her estate) as they designate, these powers of appointment are effective only when there are no life insurance policies on the life of the beneficiary included in trust assets. Generally, an inter vivos exercise of a special power of appointment could reduce the principal of a trust so that there are insufficient funds to pay the premiums on the life insurance policies. In addition, a testamentary exercise of a special power of appointment could result in a reversionary interest in the life insurance policies. In this case, the special powers of appointment are not effective when insurance policies on the life of the

> beneficiary-daughter are among trust assets. Therefore, A and B cannot exercise their special powers of appointment to gain any economic benefits of the life insurance policies.
>
> Based on the facts and representations made in your request for rulings and your subsequent submissions, we conclude that neither A nor B will possess any incidents of ownership over life insurance policies on their lives held by the trustees of their irrevocable trusts and that the proceeds of the policies will not be includible in their gross estates under section 2042(2).
>
> We express no opinion at this time with respect to the gift tax consequences to A or B where the trustees of their separate trusts invest in a nonincome-producing life insurance policy on their lives.

Letter Ruling 9748020 involved the following facts:

> Decedent's Spouse is the current beneficiary and was one of three co-trustees of Trust B. During her life, the trustees of Trust B are to distribute all of the net income of the trust to Decedent's Spouse. If the income is insufficient to provide for Decedent's Spouse's health, support, and maintenance in accordance with the standard of living she enjoyed at the time of Decedent's death, the trustees are authorized to distribute principal. Decedent's Spouse has no power of appointment over the assets in Trust B. Decedent's children and grandchildren are contingent beneficiaries. Decedent's Spouse resigned as a co-trustee of Trust B on Date 2. The Trust instrument provides that no successor trustee is to be appointed and the remaining trustees will serve as co-trustees.
>
> Trustees of Trust B propose to purchase a policy of insurance on the life of Decedent's Spouse. Trustees request a ruling that Decedent's Spouse will not possess any incidents of ownership over the life insurance policy on her life held by the trustees of Trust B and that the proceeds of the policy will not be includible in her gross estate under sections 2036 and 2042(2).

Letter Ruling 9748020 cited Reg. §§ 20.2042-1(c)(2)[4650] and 20.2042-1(c)(4) and Rev. Rul. 84-179 and reasoned and held:

> In this case, Decedent's Spouse is the current beneficiary of Trust B. During her life, the trustees of Trust B are to distribute all of the net income of the trust to Decedent's Spouse. If the income is insufficient to provide for Decedent's Spouse's health, support, and maintenance in accordance with the standard of living she enjoyed at the time of Decedent's death, the trustees are authorized to distribute principal. Decedent's children and grandchildren are contingent beneficiaries of Trust B.
>
> Because Decedent's Spouse resigned as a trustee of Trust B, Decedent's Spouse will not possess any incidents of ownership over a life insurance policy on her life purchased by the remaining trustees of Trust B and held as an asset of Trust B. Therefore, proceeds of a life insurance policy on her life purchased by the trustees of Trust B and held as an asset of Trust B will not be included in Decedent's Spouse's gross estate provided that (1) she has not transferred any assets to Trust B, (2) the premiums on the

[4650] Reg. § 20.2042-1(c)(2) is reproduced in part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

> policy are paid from the principal of Trust B, (3) she does not maintain the policy with personal assets, and (4) she is not reinstated as a trustee of Trust B.

Letter Ruling 9748029 involved the following facts:

> On May 7, 1990, A, established an irrevocable trust, Trust, for the benefit of his spouse, B, and his children. The Trust was funded with a second to die life insurance policy on the lives of A and B. The trustees of Trust are A's two children. Under the terms of the Trust, any contribution to the Trust may be withdrawn by B, provided the amount of withdrawal cannot exceed $5,000 for any calendar year. A's children have the right to withdraw a proportionate amount of any contribution not withdrawn by B, not to exceed $5,000. Each withdrawal right lapses on the earlier of (a) the last of the year in which the contribution was made, or (b) 60 days after the contribution. During A's lifetime, the trustee is authorized to use some or all of the trust income to pay premiums on policies of life insurance on the lives of A and B. After paying any insurance premium, the trustees may distribute to or for the benefit of B and the children so much of the trust income and principal as the trustees deem appropriate.
>
> After A's death, the trustees are to pay to or for the benefit of B and the children so much of the Trust's income and principal, as the trustees deem appropriate for the comfort and general welfare of those beneficiaries. Upon B's death, the trustees have discretion to pay B's burial expenses, expenses of her last illness, and death and succession taxes. Any remaining corpus is to be divided into separate shares with a separate share to be distributed to each living child and a share to be distributed per stripes to the living descendants of a deceased child.
>
> A transferred property to Trust, and Trust applied for a second to die life insurance policy on the lives of A and B. Trust has owned the policy at all times. The trustees possess all incidents of ownership in the policy. A died on January 26, 1996, survived by B. B has made no transfers to Trust. The trustees have continued to pay the premiums on the insurance policy from trust funds.
>
> Although a bank is named successor trustee, the trustees have the ability to name additional co-trustees. The trust instrument does not prohibit B from being added as an additional co-trustee.

First, the ruling cited a variety of rules, including Reg. § 20.2042-1(b), which provides:

> (1) Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life receivable by the executor or administrator, or payable to the decedent's estate. It makes no difference whether or not the estate is specifically named as the beneficiary under the terms of the policy. Thus, if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary's obligation) of such taxes, debts, or other charges is includible in the gross estate. Similarly, if the decedent purchased an insurance policy in favor of another person or a corporation as collateral security for a loan or other accommodation, its proceeds are considered to be receivable for the benefit of the estate. The amount of the loan

outstanding at the date of the decedent's death, with interest accrued to that date, will be deductible in determining the taxable estate. See § 20.2053-4.

(2) If the proceeds of an insurance policy made payable to the decedent's estate are community assets under the local community property law and, as a result, one-half of the proceeds belongs to the decedent's spouse, then only one-half of the proceeds is considered to be receivable by or for the benefit of the decedent's estate.

Letter Ruling 9748029 reasoned and held:

> In the present case, A created and funded the Trust in 1990 and made all transfers to the Trust. B has made no direct contributions nor indirect contributions by reason of the lapse of the $5,000 withdrawal right. See section 2514(e). Under the terms of the Trust, B does not possess any rights within the meaning of sections 2036 or 2038. Assuming B is not named as an additional trustee, B will not have any incidents of ownership in the policy by reason of section 20.2042-1(c)(4). Assuming B does not make any contributions to the Trust (either directly or indirectly) we conclude that the Trust and insurance policy will not be included under sections 2036, 2038, and 2042(2) in B's gross estate upon her death.
>
> However, we express no opinion regarding the application of section 2042(1) which is dependent on facts presented at the spouse's death; for example, whether the trustee will be legally bound to pay B's burial expenses, expenses of her last illness, and death and succession taxes at that time. See Rev. Rul. 77-157, 1977-1 C.B. 279.[4651]

Note that the surviving spouse in Letter Ruling 9748029 was not a trustee, did not have any power of appointment, and could not receive any distributions until after the insurance premiums were paid. If a policy on only one spouse can use decent mortality charges and the premium savings from a second-to-die policy is mainly due to a longer time to fund the death benefit, consider whether that timing of premium payments is really worth sacrificing giving the surviving spouse the control that a surviving spouse often has over a spousal limited access trust.

Letter Ruling 200314009 found no incidents of ownership where a grantor had the power to name as a successor trustee anyone except himself or any party related or subordinate to the grantor when the two designated trustees are unavailable to act as trustee or are removed; however, the grounds for removal were not spelled out. The IRS pointed out that Reg. § 20.2042-1(c)(4) provides that:

> A decedent is considered to have an incident of ownership in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The IRS looked to Rev. Rul. 77-182 (no Code § 2036 inclusion where decedent could appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process) and Rev. Rul. 95-58 (no Code § 2036 inclusion where decedent could remove the trustee and

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[4651] Rev. Rul. 77-157 ruled as to Code § 2039(c), which has since been repealed; therefore, Rev. Rul. 88-85 obsoleted Rev. Rul. 77-157.

appoint an individual or corporate successor trustee that was not related or subordinate to the decedent).[4652]

In Letter Rulings 201919002-201919003, the settlor established an irrevocable trust for the benefit of Child 1 and Child 1's descendants, with the trustee being Child 1. When the trustee planned to buy life insurance, the trustee petitioned to have the trust modified so that Child 2 (presumably Child 1/s sibling) would serve as special trustee over insurance, holding all incidents of ownership, and Child 1 would have no power of appointment over the life insurance policy. However, Child 1 had the power to change trustees, so long Child 1 did not appoint a person related to or subordinate to Child 1, within the meaning of Code § 672(c), as successor insurance trustee. Citing Rev. Rul. 84-179 but not Rev. Rul. 95-58, the ruling held:

> In this case, Child 1's powers, in the capacity as Trustee and beneficiary were eliminated prior to the acquisition of the life insurance policy on Child 1's life. Trust is the owner and beneficiary of the policy. Accordingly, when the Insurance Trustee purchased a life insurance policy on Child 1's life, Child 1 did not possess and did not have the power to exercise, any incidents of ownership in the policy acquired by Trust. Child 1 will not relinquish or transfer any incidents of ownership in the policy as a result of the modification prior to the acquisition of the policy.
>
> Accordingly, based on the facts submitted and the representations made, we conclude that Child 1 does not and will not possess any incidents of ownership over any life insurance policy on Child 1's life acquired by Trust, as amended, and that the proceeds of any policy on Child 1's life will not be includible in Child 1's gross estate under § 2042(2). The above conclusions assume that Child 1 is not serving as Insurance Trustee at the time of Child 1's death, or Trust is modified such that Child 1 regains fiduciary powers over life insurance on Child 1's life.

A decedent's right to veto a change in the transfer of a policy, where the decedent could gain no economic benefits from the veto power, did not constitute incidents of ownership.[4653]

Letter Ruling 200404013 involved the following facts:

> On Date 1, A created and funded an irrevocable trust, Trust. Under the terms of Trust, the co-trustees (B, A's spouse, and Corporate Trustee) have absolute discretion to distribute income and corpus to A's children and their descendants for such person's care, health, education, maintenance, support, purchase or improvement of home, to establish a professional practice, or acquire an interest in a business. Upon the death of A, or earlier if the Trust fails to qualify as a grantor trust for federal income tax purposes, the trustees are to segregate any shares of stock of a corporation which is an S corporation for federal income tax purposes. The segregated stock is to be held in separate trusts (hereinafter referred to as separate trusts), one trust for each child or deceased child of A. The remainder of any Trust assets are to be held in trusts (hereinafter referred to as remainder trusts), one trust for each child or deceased child of A.

[4652] "Related or subordinate" looked to Code § 672(c) – see fn. 2574 in part II.J.3.h Drafting for Flexibility in Trust Income Taxation.
[4653] *Estate of Rockwell v. Commissioner*, 779 F.2d 931 (3rd Cir. 1985).

Under the terms of the separate trusts, the net income is to be paid quarterly to the designated child (or in the case of a trust created for a deceased child, the child's descendants). The trustees also have absolute discretion to distribute corpus to such child (or child's descendants as the case may be) for care, health, education, maintenance, support, purchase or improvement of home, to establish a professional practice, or acquire an interest in a business. Upon the death of a child, any remaining corpus that has not been appointed pursuant to a testamentary special power of appointment, is to be held in further trust, under terms and conditions described above, for the child's descendants.

Under the terms of the remainder trusts, the trustees have absolute discretion to distribute income and corpus to A's child and that child's descendants for such person's care, health, education, maintenance, support, purchase or improvement of home, to establish a professional practice, or acquire an interest in a business. Upon the death of a child, any remaining corpus that has not been appointed pursuant to a testamentary special power of appointment, is to be held in further trust, under terms and conditions described above, for the child's descendants.

In the case of the Trust, separate trusts, and remainder trusts, no income or principal may be distributed for support or maintenance of a beneficiary if A or B is legally obligated to support such beneficiary.

Under the terms of Trust, the Corporate Trustee may be replaced by the vote of three designated advisors. Under Article XVII, a trustee, by written instrument, may renounce in whole or in part any one or more powers, authorities or discretion given by Trust or by law to that trustee. Under Article XXIV, A may not be appointed trustee, nor may A remove a trustee or appoint a successor trustee.

Trust purchased a joint and survivor life insurance policy on the lives of A and B. It is represented that Trust will make ten annual premium payments and that the Trust should have adequate income each year to fully pay the annual premium. B, as trustee, also executed a written instrument renouncing her right as trustee to: (1) change the beneficiary of the policy; (2) revoke any change of beneficiary; (3) assign the policy; (4) revoke any assignment of the policy; In addition, B has renounced any right to make contributions to Trust and to appoint a successor advisor.

It is represented that A funded Trust, but that B has consented to treat the gift as made one-half by A and one-half by B under § 2513. Further, it is represented that sufficient GST exemption under § 2631 was allocated to Trust, such that Trust has a zero inclusion ratio for GST tax purposes.

Letter Ruling 200404013 reasoned and held:

In the present case, neither A or B have any beneficial interest in Trust. Trust has purchased the life insurance policy using funds held in trust. Further, it is represented that neither A nor B will make any additional transfers to Trust for the purpose of paying premiums on the policy. Under these circumstances, we conclude that the purchase by Trust of the life policy with Trust assets will not be a treated as a gift by A or B.

In the present case, Trust purchased and owns the life insurance policy. Trust is also the designated beneficiary of the policy proceeds and Trust will also make all future premium payments from Trust assets. Accordingly, we conclude that A will not possess any incidents of ownership, under § 2042(2) and § 20.2042-1(c)(2), in the policies owned by Trust. Further, we conclude that the proceeds of the policies payable to the trustee of Trust will not be includible, under § 2042(2) in the gross estate of A. Further, in the present case, it is represented that B has not transferred any property to Trust, nor will B make any transfers to Trust in the future to maintain the policy. Accordingly, notwithstanding that B is a trustee of Trust, we conclude that B will not possess any incidents of ownership, under § 2042(2) and § 20.2042-1(c)(2), in the policies owned by Trust and the proceeds of the policies payable to the trustee of Trust will not be includible, under § 2042(2) in the gross estate of B. Rev. Rul. 84-179.

> In the present case, A and B have treated A's transfer to Trust, as made one-half by each under § 2513. Under § 2652(a)(2), if the requirements for signifying consent under § 2513(b) were satisfied, A and B are each deemed the transferor for Federal GST tax purposes of one-half of A's gift to Trust. It is represented that A and B have each allocated sufficient GST exemption to the Trust such that Trust will have an inclusion ratio of zero for GST tax purposes. As noted above, it is represented that the insurance policy was purchased with current trust assets and all future premium payments will be paid from Trust assets. Accordingly we conclude that the purchase of the insurance policy by Trust, will not affect the identity of the transferors of Trust for GST tax purposes, nor will the purchase effect the inclusion ratio with respect to Trust.

Letter Ruling 200518005 involved the following facts:

> Trust A and Trust B were not established by Taxpayer. Pursuant to the terms of each trust, Taxpayer is to receive the net income of each trust for her life. Upon her death, the principal of each trust is to be divided into equal shares for the benefit of Taxpayer's children. Taxpayer was a co-trustee of Trust A and Trust B, but on Date 1, she renounced all of her rights as co-trustee of Trust A and Trust B in connection with life insurance policies on her life. Life insurance policies on Taxpayer's life were purchased by Trusts A and B using trust corpus subsequent to Taxpayer's renunciation. Taxpayer resigned as co-trustee of Trust A and Trust B on Date 2 and Date 3, respectively. Trustee A and Trustee B are the current co-trustees of both trusts.

Letter Ruling 200518005 reasoned and held:

> In the present case, Taxpayer is the current income beneficiary of Trust A and Trust B. During her life, the trustees of Trust A and Trust B are to distribute all of the net income of each trust to Taxpayer. Upon Taxpayer's death, the trust is to be divided into equal shares for Taxpayer's issue. It has been represented that Taxpayer will not contribute assets to Trust A or Trust B, or maintain the life insurance policies held as assets of Trust A and Trust B with Taxpayer's personal assets.

> Based on the foregoing, Taxpayer will not possess any incidents of ownership over the life insurance policies held as assets of Trust A and Trust B because Taxpayer renounced her rights as co-trustee of Trust A and Trust B in connection with the life insurance policies and ultimately resigned as co-trustee of the trusts. Therefore, we conclude that the proceeds of the life insurance policies held as assets of Trust A and Trust B will not be included in Taxpayer's gross estate under § 2042(2) or 2035, provided the premiums for the policies are not paid from the income of Trust A or Trust B.

Letter Ruling 200617008 involved the following facts:

> The Trustees are to pay Wife the entire net income and so much of the principal of Trust A as the trustees in their absolute discretion determine. Trust A is to terminate upon the death of Wife, and the balance of the Trust A corpus is to be paid to Husband's then living issue, per stirpes. The balance of the Trust corpus (after providing for the funding of Trust A) is to be paid to husband's then living issue, per stirpes, provided that any property payable to a child of Husband who had not attained the age of 29 is to be held in further trust for the benefit of the child.
>
> Article Fifth (I) of the Trust Agreement provides that if any person currently eligible to receive any principal or income from any trust created under the terms of Trust is acting as a trustee, then such trustee shall have no power whatsoever to make or participate in making decisions affecting in any way the disposition of the income or principal of such trust to himself or herself, including determining how much income or principal should be distributed and whether the trust should be terminated.
>
> … Wife and Father are currently serving as co-trustees of Trust A.
>
> Wife proposes to resign as co-trustee of Trust A. Subsequent to Wife's resignation, Father, as trustee of Trust A, will apply for and purchase a policy of insurance on Wife's life. Trust A will be the owner and beneficiary of the policy. It is represented that the principal of Trust A will be used to pay the premiums on the policy and that the annual premiums will be less than Q% of the principal of Trust A. Wife will not pay any premiums with respect to the policy or otherwise contribute towards the maintenance of the policy. All the income of Trust A will continue to be paid to Wife.

Letter Ruling 200617008 reasoned and held:

> In the present case, Wife will resign as co-trustee of Trust A prior to the acquisition by Trust A of the life insurance policy on Wife's life. Trust A will be the owner and beneficiary of the policy. Accordingly, because Wife is resigning as co-trustee prior to the acquisition of the policy, Wife will never possess, or have the power to exercise, any incidents of ownership in the policy to be acquired by Trust A, nor will she relinquish or transfer any incidents of ownership in the policy by resigning as co-trustee prior to the acquisition of the policy. Further, it is represented that only trust principal will be used to pay the premiums on the policy and the annual premiums will be less than Q% of the Trust A principal. All the income of Trust A will continue to be paid to Wife. In addition, Wife has not transferred, nor will she transfer any assets to Trust A, and she will not pay any premiums with respect to the policy to be held as an asset of Trust A.
>
> Based on the foregoing, we conclude that the proceeds of the life insurance policy to be acquired by Trust A, as described above, will not be includible in Wife's gross estate under section 2042(2). Further, the policy proceeds will not be includible under section 2035(a), if Wife dies within three years of resigning as co-trustee of Trust A. The above conclusions assume that Wife is not reinstated as co-trustee and is not serving as co-trustee at the time of her death, or after being reinstated, subsequently resigns within three years of death. See Rev. Rul. 84-179.

Letter Ruling 201327010 involved the following facts:

> Over a period of years, Taxpayer s spouse, Decedent, purchased several life insurance policies naming Taxpayer as the insured and Decedent s estate as the beneficiary. It is represented that Taxpayer paid none of the premiums on the policies and, as well, that Taxpayer anticipates that no further premiums will be due on the policies.
>
> Decedent died on Date 1. Under Decedent s will ownership of the policies passed to Family Trust. Under the terms of Family Trust, income and principal is distributable to Taxpayer and Decedent s descendants in the discretion of the trustee. The remainder is payable to such persons, other than Taxpayer, Taxpayer s estate, Taxpayer s creditors, or the creditors of Taxpayer s estate, as Taxpayer shall appoint by will, and in default of appointment, to certain takers in default. Taxpayer is named the trustee of Family Trust, as well as the protector of Family Trust, with the power to remove and replace trustees. As trustee, Taxpayer possessed the incidents of ownership in the policies.
>
> On Date 2, pursuant to its terms, Family Trust was divided into two trusts, Family Trust 1 and Family Trust 2. Family Trust 1 was funded with the insurance policies, while Family Trust 2 was funded with the remaining assets. Concurrent with the division of Family Trust, Taxpayer relinquished his roles as trustee and protector of Family Trust 1, his ability to be reappointed as trustee of Family Trust 1, and his power of appointment over the assets of Family Trust 1. Taxpayer retained his beneficial interest in Family Trust 1 as a permissible distributee of trust income and principal.

Letter Ruling 201327010 reasoned and held:

> Here, prior to the Date 2 transaction, Family Trust held policies of insurance on Taxpayer's life. Under the terms of Decedent s will, Taxpayer possessed trustee powers over the Family Trust assets, a beneficial interest in Family Trust, and a testamentary power of appointment over the Family Trust assets. Taxpayer could exercise in a fiduciary capacity the trustee powers over the incidents of ownership in the policies of insurance on Taxpayer's life for Taxpayer's own benefit, and could exercise in his individual capacity the power of appointment over the proceeds of the policies. On these facts, both the fiduciary powers and individually held powers constitute incidents of ownership in the policies, without regard to how those powers were acquired and without consideration of whether Taxpayer transferred property to Family Trust. Section 20.2042-1(c)(4). After the Date 2 transactions, however, with regard to Family Trust 1, Taxpayer held only a beneficial interest as a permissible distributee of income and corpus, but no powers over the policies or their proceeds, and thus, no incidents of ownership for purposes of § 2042(2). Assuming that Taxpayer survives the three-year period of § 2035, the proceeds of the policies will not be includible in Taxpayer s gross estate. Section 20.2042-1(c)(1).

The mere right to the dividends, by itself, is not an incident of ownership that would cause the value of the insurance proceeds to be included in Decedent's gross estate under Code § 2042(2).[4654] This conclusion was based on the view that dividends represent a return of

[4654] CCA 201328030.

premiums[4655] and did not address whether dividends in excess of premiums would be treated differently.

Letter Ruling 201919002 involved the following facts:

> On Date 1, Settlor established an irrevocable trust, Trust, for the benefit of Child 1 and Child 1's descendants. The Trustee of Trust is Child 1. Settlor predeceased Child 1. It is represented that Child 1 has not made any contributions to Trust and does not intend to make any contributions to Trust.
>
> Section 2.1 of Trust provides that the Trustee is expressly granted the power to own and acquire life insurance and to pay the premiums on existing life insurance on the life of any person in which the trust or its beneficiaries may have an insurable interest. The ownership of any and all policies of insurance applied for and purchased by the Trustee or transferred and assigned to the Trustee is irrevocably vested in the Trustee.
>
> Under Section 2.4, the Trustee is vested with all rights, powers, options, elections, privileges and incidents of ownership in all insurance policies owned by Trust.
>
> Section 2.5 provides that the Trustee shall have the power to use all or any part of the net income or corpus of Trust to pay all or any part of any premiums or other charges due on any insurance policies held in trust. Provided, however, notwithstanding any contrary provision in this paragraph, in the event the Trust owns any life insurance on the life of Settlor, premium payments shall only be made out of corpus, and not out of income (as determined for federal income tax purposes under Subpart E of Part I, Subchapter J, Chapter 1, Subtitle A of the Internal Revenue Code (Code)).
>
> Under Article III, during Child 1's lifetime, the Trustee shall have the power to distribute net income and corpus of Trust as Trustee may determine to be appropriate to provide for the health, support, maintenance and education of Child 1 and Child 1's descendants. Any undistributed net income shall be accumulated and added to the corpus of Trust.
>
> Section 6.1 provides that upon the death of Child 1, Child 1 shall have a testamentary special power of appointment over the remaining assets of Trust limited to the class consisting of Child 1's descendants. To the extent Child 1 does not exercise or ineffectively exercises Child 1's testamentary special power of appointment, then the Trustee shall apportion the property of Trust into separate equal trusts, one for the benefit of each of Child 1's then living children (Child's Trust) and one trust for the benefit of the descendants (Descendant's Trust), taken collectively, of each child of Child 1 who is then deceased leaving descendants then surviving. Moreover, Sections 6.2 and 6.3 grant a testamentary special power of appointment to the primary beneficiary of a Child's Trust or a Descendant's Trust.
>
> Under Section 7.2, Child 1 shall have the power to appoint one or more persons, individual or corporate, to serve as Co-Trustee or sole Trustee of Trust or the separate

[4655] CCA 201328030 cited *Estate of Bowers v. Commissioner*, 23 T.C. 911, 917 (1955) (the right to dividends, which may be applied against a current premium, is nothing more than a reduction in the amount of premiums paid rather than a right to the income of the policy) and *Estate of Jordahl v. Commissioner*, 65 T.C. 92, 99 (1975) (since dividends are merely a reduction in the amount of premiums paid, the right to dividends is not an incident of ownership).

trusts created hereunder and shall have the power to remove or replace any Co-Trustee or sole Trustee whether named in Trust or appointed pursuant to Article VII. If Child 1 should die, resign or be unable or unwilling to serve as Trustee for any reason, or fail to appoint a successor, then Settlor appoints Child 1's spouse, Spouse, as Trustee. If Spouse is unable to serve for any reason, then Settlor appoints Child 2. Upon the death of Child 1, if Child 1 has not appointed a trustee to succeed upon Child 1's death, Settlor appoints each child of Child 1 as sole Trustee of any separate trust created for his or her benefit.

Section 7.12 provides that Settlor does not intend that the Trustee have any power over trust property that, if held by the Trustee in a fiduciary capacity, would result in inclusion of trust assets in the estate of the Trustee for federal estate tax purposes. To this end, the Settlor appoints the Co-Trustee or, if none, the next Successor Trustee named or appointed under Article VII who is qualified to serve as Trustee and who does not suffer the same disability, as Special Co-Trustee during any period in which a trust governed by this agreement provides for current distribution to beneficiaries to whom the primary Trustee owes a legal obligation of support or contains property over which the primary Trustee's powers would result in such inclusion.

Section 7.12(a) provides that a Special Co-Trustee shall be appointed if a trust governed under this agreement owns or otherwise possesses any incidents of ownership over any life insurance policies on the life of the primary Trustee within the meaning of § 2042.

Section 7.12(c) provides that a Special Co-Trustee shall be appointed if a trust governed under this agreement provides for current distributions to beneficiaries to whom the primary Trustee has a legal obligation of support. The Special Co-Trustee shall have the sole power to determine the amount and timing of any discretionary distribution to a beneficiary to whom the primary Trustee has a legal obligation of support. The primary Trustee's powers at such times shall be limited to management of trust assets and distributions to beneficiaries to whom the primary Trustee owes no legal support obligation.

In Year 1, Trustee proposed to purchase a life insurance policy on the joint lives of Child 1 and Spouse. However, Section 6.1 of Trust provides Child 1 with a testamentary special power of appointment over all assets contained in Trust. As a result, if Trust owned a life insurance policy on the life of Child 1, there is a risk that the life insurance death benefit proceeds will be included in Child 1's gross estate for federal estate tax purposes upon Child 1's death.

Accordingly, Child 1, in the capacity of Trustee of Trust, petitioned Court to modify the terms of Trust to remove Child 1's testamentary special power of appointment over any life insurance policy on Child 1's life or the proceeds of such policy; to add an Insurance Trustee, who will have sole authority over any insurance policies on the life of Child 1 purchased by Trust; and to modify Trust to require that premium payments on life insurance policies on Child 1 must be paid out of Trust corpus. On Date 2, in Year 1, a Final Judgment of Modification was issued by Court approving the modification of Trust.

Pursuant to the Final Judgment of Modification, Trust is modified as follows: Section 2.5, as modified, provides that if Trust owns any life insurance on the life of Settlor, a beneficiary, or a trustee, premium payments shall only be made out of corpus, and not out of income (as determined for federal income tax purposes under Subpart E of Part I, Subchapter J, Chapter 1, Subtitle A of the Internal Revenue Code (Code)).

Sections 6.1, 6.2 and 6.3, as modified, provide that a holder of a testamentary special power of appointment under the terms of Trust, Child's Trust or Descendant's Trust is excluded from exercising the power over any life insurance policy on such beneficiary's life or proceeds of such policy on such beneficiary's life.

Section 7.12(a) of Trust, as modified, is deleted and replaced with the following:

> Notwithstanding the foregoing procedure, [Child 2] is appointed as Insurance Trustee (hereinafter referred to as "Insurance Trustee") if a trust governed by this Agreement intends to purchase, purchases, owns or otherwise possesses any incidents of ownership over any life insurance policies on the life of the primary Trustee within the meaning of § 2042 of the Internal Revenue Code. [Child 1] shall have the power to: (i) change the Insurance Trustee succession herein, (ii) appoint one or more persons, individual or corporate, excluding [Child 1], to serve as Insurance Trustee or Co-Trustees of this trust or any trust created hereunder, and (iii) remove such persons appointed, whether now serving or appointed to serve in the future. Provided, however, [Child 1] shall not have the power to appoint a person related to or subordinate to [Child 1], within the meaning of § 672(c) of the Internal Revenue Code, as successor Insurance Trustee. The Insurance Trustee shall have the power to maintain the policies in which the applicable trust has an ownership interest and pay the trust's proportionate share of the premiums thereon. If for any reason there are not sufficient funds to pay the premiums and maintain the policies in force, the Insurance Trustee shall have authority to accept paid-up insurance for the policies. Additionally, if necessary for the health, support or maintenance of the beneficiary of that trust, the Insurance Trustee shall have complete authority to surrender the said policies, or borrow on them, and to utilize the proceeds for the benefit of that trust beneficiary. The Insurance Trustee shall not be liable to any beneficiary by virtue of its decision in exercising its discretion and in carrying out these instructions. If [Child 2] should die, resign or be unable or unwilling to exercise the power described in this subparagraph, unless [Child 1] has otherwise named a successor Insurance Trustee, then a majority of the beneficiaries then entitled or permitted to receive income from each separate trust hereunder, per stirpes and not per capita, who are at least twenty-one (21) years of age, shall have the authority to appoint a successor Insurance Trustee, other than Settlor.

Statute provides, in pertinent part, that on the petition of a trustee or a beneficiary, a court may order that the terms of the trust be modified if because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust; modification of administrative, non-dispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration; the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or the order is not inconsistent with the material purpose of the trust and all beneficiaries of the trust have consented or are deemed to have consented to the order.

In Year 2, subsequent to the Court's Final Judgment, Child 2, in the capacity of Insurance Trustee, purchased a second-to-die policy on the lives of Child 1 and Spouse.

Letter Ruling 201919002 reasoned and held:

> In the present case, prior to the modifications of Trust, Section 2.1 of Trust expressly granted the Trustee the power to own and acquire life insurance and to pay the premiums on existing life insurance on the life of any person in which the trust or its beneficiaries may have an insurable interest. The ownership of any and all policies of insurance applied for and purchased by the Trustee or transferred and assigned to the Trustee is irrevocably vested in the Trustee. Under Section 2.4, Child 1, as the Trustee, is vested with all rights, powers, options, elections, privileges and incidents of ownership in all insurance policies owned by Trust. Accordingly, prior to the modifications, Child 1 possessed all incidents of ownership in any life insurance policy on Child 1's life that the Trust may acquire.
>
> The modifications to Trust relinquished Trustee's powers with respect to any life insurance policy on Child 1's life acquired by Trust and granted such powers to an Insurance Trustee. Under Section 7.12(a), as modified, Child 2 is appointed as Insurance Trustee with power to maintain and pay premiums on a life insurance policy on the life of Child 1. Child 2 shall have complete authority to surrender policies, borrow on them, or utilize the proceeds for the benefit of the beneficiary if necessary for the health, support or maintenance of the beneficiary. Accordingly, Trustee is precluded from exercising any power normally conferred on the owner of a policy.
>
> Child 1 retains a beneficial interest in income and principal of Trust, subject to an ascertainable standard. However, under Section 2.5, as modified, premium payments will only be made out of corpus and not income. In addition, Child 1 has not made any contributions to Trust and further represents that Child 1 will not make any contributions to Trust.
>
> Further, prior to the modifications of Trust, Child 1 possessed a testamentary special power of appointment over the Trust principal, which would include any proceeds from life insurance on the life of Child 1 that Trust may hold. This power gave Child 1 the power to change the beneficial ownership of the proceeds. However, the modifications to Trust restrict Child 1's testamentary special power of appointment. Under Section 6.1, as modified, Child 1 may not exercise Child 1's testamentary special power of appointment over any life insurance policies on the life of Child 1. Accordingly, Child 1 may not exercise Child 1's testamentary special power of appointment to change the beneficial interests in the proceeds of the life insurance policy on Child 1's life.
>
> In this case, Child 1's powers, in the capacity as Trustee and beneficiary were eliminated prior to the acquisition of the life insurance policy on Child 1's life. Trust is the owner and beneficiary of the policy. Accordingly, when the Insurance Trustee purchased a life insurance policy on Child 1's life, Child 1 did not possess and did not have the power to exercise, any incidents of ownership in the policy acquired by Trust. Child 1 will not relinquish or transfer any incidents of ownership in the policy as a result of the modification prior to the acquisition of the policy.
>
> Accordingly, based on the facts submitted and the representations made, we conclude that Child 1 does not and will not possess any incidents of ownership over any life insurance policy on Child 1's life acquired by Trust, as amended, and that the proceeds of any policy on Child 1's life will not be includible in Child 1's gross estate under § 2042(2). The above conclusions assume that Child 1 is not serving as Insurance

Trustee at the time of Child 1's death, or Trust is modified such that Child 1 regains fiduciary powers over life insurance on Child 1's life.

We neither express nor imply any opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Reviewing various authorities cited above, Mezzullo, T.M. 826-3rd, *Life Insurance*, Detailed Analysis Part I.D., "Special Issues in Trust-Owned Insurance: Application of Incidents of Ownership Test," subpart 1, "What Are Consequences of Decedent Serving as Trustee of Trust Holding Insurance Policy on Decedent's Life?" point e, "Practical Application of Rules," suggests:

- The most cautious approach is for the insured not to serve as a trustee of a trust that holds insurance policies on his or her life, whether or not he or she is the transferor.

- If the insured is to serve as a trustee in a *Estate of Skifter v. Commissioner*[94] situation (that is, where the trust is created by someone other than the insured), certain precautions should be taken. First, the insured should not have a beneficial interest in the trust. If the insured's spouse or children are trust beneficiaries, language should be used precluding trust distributions that may satisfy the insured's obligation of support to the spouse and children. Second, there should be a source for premium payments other than the insured because, under Rev. Rul. 84-179, the insured's powers as trustee may result in the inclusion of the insurance policies in his or her gross estate, if the insured furnished "consideration for maintaining the policies." Thus, it will probably be necessary for the trust holding the insurance policies to hold other assets that can be used to pay premiums.

- If there is a plan for a trust to acquire a policy of insurance on the life of a trustee who is a beneficiary of the trust, the trustee should, before the policy is acquired, either renounce all powers that may affect the policy or resign as trustee.

- Notwithstanding the result in *Estate of Bloch v. Commissioner*,[95] the insured/trustee should not use the trust property for his own benefit in contravention of the terms of the trust. At some point, a court may conclude that the transaction is a sham. Moreover, the planning objective is to avoid, rather than encourage, litigation with the IRS.

- Where a question of inclusion in the decedent's gross estate of the proceeds of an insurance policy on the decedent's life is raised not in a planning context, but as a fait accompli, it should not be assumed that inclusion is inevitable, even if the decedent is transferor, trustee, and beneficiary. As in *Estate of Jordahl v. Commissioner*,[96] the powers of the decedent (under the terms of the relevant document and based on the actual facts) should be analyzed closely in determining whether, in fact, the decedent possessed any incidents of ownership.

- [94] 468 F.2d 699 (2d Cir. 1972).

- [95] 78 T.C. 850 (1982).

- [96] 65 T.C. 92 (1975), *acq.*, 1977-1 C.B. 1.

Reviewing various authorities cited above, Mezzullo, T.M. 826-3rd, *Life Insurance*, Detailed Analysis Part I.D., "Special Issues in Trust-Owned Insurance: Application of Incidents of Ownership Test," subpart 2, "What Are Consequences if Decedent Is Beneficiary of Trust Holding Insurance Policy on Decedent's Life?" point g, "Guidelines," suggests:

> There are no definitive answers, but the following thoughts are offered as possible guidelines in the insured/beneficiary arena:
>
> - In a number of rulings, the IRS has ruled favorably where the insured/beneficiary was entitled to the income. However, if the insured has the right, as income beneficiary, to demand that the policy be converted to income-producing assets, there is a significant risk that (1) this could create a § 2042 problem under the reasoning of *Estate of Fruehauf v. Commissioner*[99] and/or (2) the failure to exercise the right could have adverse gift and estate tax consequences.
>
> [99] 427 F.2d 80 (6th Cir. 1970).
>
> - If the insured is entitled to income, the trust should provide that all premium payments will be made from principal, although this will have the effect of reducing the income in the future.
> - If distributions to the beneficiary/insured are permitted with no reference to a standard, the insured has no right to the economic benefit of the policy and § 2042 should not apply.
> - If distributions can be made to the insured only in accordance with a standard and the standard is not satisfied, § 2042 should not apply because no distribution could be made to the beneficiary.
> - If distributions are required to be made to the insured only in accordance with a standard and the standard is satisfied, § 2042 should not apply. Even though the beneficiary has a right to distributions (which right, if not enforced, may create estate and gift tax issues in and of itself), the beneficiary should have no § 2042 economic benefit in the policy if he or she has no right to demand distribution of the policy itself.
> - If distributions are permitted (but not required) to be made to the insured only in accordance with a standard and the standard is satisfied, possible § 2042 includibility is even more remote than in the bullet point immediately above.
> - All of the above assumes that the insured has not made contributions to the trust. While it may well be that contributions by the insured should have no relevance in the § 2042 context (or at least in this aspect of § 2042), the fact that the favorable result in Rev. Rul. 84-179 (and in each of the private rulings discussed above) is contingent on the no-contribution condition raises a significant concern.
> - All of the above assumes that the insured is not a trustee of the trust (or at least has no distribution powers as trustee). While PLR 9111028 shows that it may be possible for the insured/beneficiary to serve as trustee, *Fruehauf* points out the potential danger. A fair inference from the private letter rulings discussed above is that the renunciations and resignations were a prerequisite to the favorable rulings.

- The beneficiary/insured should not hold any power of appointment (inter vivos or testamentary) over the insurance policy.

- *Bottom* Line: The taxpayer may want to consider requesting a private letter ruling. While there are certainly trusts with other terms that should be outside the scope of § 2042, a conservative approach is to draft a trust in which (1) the only permissible distributions to the insured are in the discretion of the trustee (without a standard), (2) distribution to the insured of any insurance policy on his or her life is prohibited, and (3) the insured has no power of appointment over any such policies.

To me, the focus seems to be whether the beneficiary might have been able to make a claim on the money used to pay premiums because the trustee diverted to the policy money that should have been distributed to the beneficiary. I think that this emphasis is misplaced, in that the beneficiary cannot control the trustee's actions and should not be imputed incidents of ownership unless the beneficiary actually obtains authority to exercise incidents of ownership; however, the IRS' and courts' opinion is much more important than my view. To avoid these concerns, the trustee might consider forming a partnership to hold the policy.[4656]

II.Q.4.i.ii.(b). Corporate Ownership of Policy

However, redemptions require further analysis, as do arrangements for cross-purchase agreements when all of the parties hold policies on each other through an entity. If a decedent is the sole or controlling shareholder of a corporation that owns an insurance policy on the decedent's life, then the decedent will not be deemed to possess incidents of ownership as a result of the decedent's stock ownership so long as the proceeds of the policy are payable to the corporation.

Reg. 20.2042-1(c)(6) provides:

> In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholder, the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corporation for purposes of the preceding sentence. See § 20.2031-2(f) for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock. Except as hereinafter provided with respect to a group-term life insurance policy, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent's stock holdings in the corporation for purposes of section 2031, any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through his stock ownership where the decedent is the sole or controlling stockholder. Thus, for example, if the decedent is the controlling stockholder in a corporation, and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership and the proceeds will be included in his gross estate under section 2042. If in this example the

[4656] See text accompanying fns. 3069-3070 in part II.J.19.b Comparing Annuity to Life Insurance.

> policy proceeds had been payable 40 percent to decedent's spouse and 60 percent to the corporation, only 40 percent of the proceeds would be included in decedent's gross estate under section 2042. For purposes of this subparagraph, the decedent will not be deemed to be the controlling stockholder of a corporation unless, at the time of his death, he owned stock possessing more than 50 percent of the total combined voting power of the corporation. Solely for purposes of the preceding sentence, a decedent shall be considered to be the owner of only the stock with respect to which legal title was held, at the time of his death, by (i) the decedent (or his agent or nominee); (ii) the decedent and another person jointly (but only the proportionate number of shares which corresponds to the portion of the total consideration which is considered to be furnished by the decedent for purposes of section 2040 and the regulations thereunder); and (iii) by a trustee of a voting trust (to the extent of the decedent's beneficial interest therein) or any other trust with respect to which the decedent was treated as an owner under subpart E, part I, subchapter J, chapter 1 of the Code immediately prior to his death. In the case of group-term life insurance, as defined in the regulations under section 79, the power to surrender or cancel a policy held by a corporation shall not be attributed to any decedent through his stock ownership.

Letter Ruling 9511009 involved a transfer from corporations of policies on the lives of both shareholders, with each shareholder receiving the policies on the other's life to facilitate a cross-purchase:

> B1 and B2 together own 100% of the stock of Corporation 1 and Corporation 2 (Corporations). B1 and B2 also together own 100% interests in Partnership 1 and Partnership 2 (Partnerships). Corporations currently own various life insurance policies on the lives of Partners. Corporations are the beneficiaries of these policies and make all of the premium payments.
>
> Under the terms of the shareholder's agreement currently in force, on the death of a shareholder, the surviving shareholder is required to purchase, and the estate of the deceased shareholder is required to sell, the deceased shareholder's stock.
>
> Separately, all of the parties mentioned herein have now entered into a Stock Purchase Agreement and Partnership Interest Purchase Agreement (Stock Purchase Agreement) which supersedes the earlier Stock Purchase Agreement and Amended Stock Transfer Restriction Agreement regarding how the stock or partnership interests will be purchased on the death of either Partner.
>
> Corporations propose to distribute the life insurance policies to Partners for cash surrender value. Partners will receive the policies insuring the life of the other partner/shareholder. Contemporaneously, Partners will assign the policies to Trust. Trust will be the beneficiary of the policies and the trustee will be an unrelated third party. Partners represent that Trust is a grantor trust under sections 671-677 of the Code. Partners will make payments to Trust in the amount of the premiums necessary to maintain the policies.
>
> The terms of Trust require that, after the death of the first of Partners to die, the trustee will distribute the proceeds of the policies to the decedent's estate on behalf of the surviving Partner in payment of the purchase price of the stock of Corporations the survivor is required to purchase. If the purchase price of the stock as set forth in the

> partner's/shareholder's agreement is less than the amount of the proceeds, any excess insurance proceeds will be distributed to the surviving partner/shareholder.

Letter Ruling 9511009 reasoned:

> In the present case, Partners will assign the polices to an irrevocable life insurance trust (Trust). The beneficiary of the policies at the death of the first Partner to die will be Trust. The trustee of Trust and not Partners will hold all incidents of ownership on the polices. Accordingly, neither Partners will hold incidents of ownership in the policies on their lives during the time the policies are held by Trust.
>
> Further, the terms of Trust require that the trustee distribute the proceeds of the policies to the estate of the first Partner to die on behalf of the surviving partner/shareholder, in payment for the stock the survivor is required to purchase, and the decedent's estate is required to sell. Any proceed in excess of the amount required under the shareholder's agreement to purchase the stock will be distributed to the surviving Partner. Thus, any proceeds received by the decedent's estate will be remitted on behalf of the survivor as payment for the purchase of decedent's stock in Corporation, and will not be received by the executor as the beneficiary, either directly or indirectly, of the insurance proceeds.
>
> In the present case, Partners will hold incidents of ownership over the insurance policies during the time in which the policies are held by Partners as individuals. However, the policies held by each Partner during this time will be the policies insuring the life of the other Partner. Accordingly, the policies would not be includible in the gross estate of the Partner holding the policies under section 2042 of the Code if that Partner had retained the policies until his death and, thus, the proceeds would not be includible in the gross estate of that Partner under section 2035 if the Partner dies within three years of the transferring the policies to Trust.

Letter Ruling 9511009 held:

> The policy proceeds will not be received by the executor of Partners' estate for purposes of section 2042(1) of the Code, nor will either Partner hold incidents of ownership to the irrevocable life insurance trust. Thus, the proceeds of the polices will not be includible under section 2042 in the gross estate of the insured Partner while the policies are held by Trust.

II.Q.4.i.ii.(c). Partnership Ownership of Policy

Neither Code § 2042 nor its Regulations specifically address the issues raised by insurance owned by a partnership in which the insured is a partner. However, case law and IRS rulings have analyzed these issues. The Tax Court has held that a general partner does not possess incidents of ownership in a policy that names a general partnership as the owner and beneficiary if the policy was purchased in the partnership's ordinary course of business and the insured partner owned less than a 50% interest in the general partnership.[4657] Rev. Rul. 83-147 held that a partner does possess incidents of ownership if the policy on the partner's life is owned by the partnership, designates a member of the partner's family as the beneficiary, and premiums were paid by the partnership in partial satisfaction of the partner's share of

[4657] *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq*. in result, 1959-1 C.B. 4, *aff'd* on another issue 244 F.2d 436 (4th Cir.), *cert. denied*, 355 U.S. 827 (1957).

partnership income. The ruling stated that the result was different than the Tax Court case because the beneficiary was not the partnership.

In a number of Letter Rulings, the IRS has addressed Code § 2042 with respect to a partnership that owns and is designated as the beneficiary of an insurance policy on the life of one of its partners.

Letter Ruling 9623024 held that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement states that the proceeds, once received by the partnership, can be distributed to the remaining partners in proportion to their interests to the extent that the proceeds from the policy were not needed to pay the partnership's obligations. The IRS reasoned that the value of the deceased partner's interest would include his pro rata portion of the proceeds and therefore inclusion under Code § 2042 would amount to unwarranted double counting of the proceeds.

Letter Rulings 9625022 and 9625023 ruled that life insurance proceeds would not be included in the estate of a member in a limited liability company (that was taxed as a partnership) who could not participate in decisions regarding a policy insuring the member's life held. Letter Rulings 9625013-9625019 had the same result and also involved using the proceeds to fund the purchase of a deceased owner's share of a related corporation and also of the limited liability company, which held real estate that it rented to the corporation.

Letter Rulings 9843024 and 200111038 held that the insured limited partner does not possess incidents of ownership in the policy if the partnership agreement precludes the limited partners from exercising any control over the partnership's management and investment activities.

Letter Ruling 200017051 ruled that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement expressly states that an insured partner "had no right or power to exercise or to otherwise participate in the exercise of any of the incidents of ownership with respect to such policy or policies."[4658]

In Letter Ruling 200214028, the IRS ruled that the insured general partner did not possess incidents of ownership because the proceeds were payable to or for the benefit of the partnership. In that case, the partnership agreement required that the proceeds be used to redeem the insured partner's interest in the partnership.

TAM 200432015 dealt with Code section 2042 and the transfer of insurance policies to a limited liability company. The TAM deals with Code §§ 2035 and 2042 and involves an insured who transferred an insurance policy on his own life to a limited liability company. If none of the insureds own policies on their own lives that they transfer to a limited liability company, the TAM would not apply.

II.Q.4.i.iii. IRS' Response to Request that Resulted in Letter Ruling 200747002

In response to my ruling request, Letter Ruling 200747002 held that none of the insureds possessed incidents of ownership on the policies that the others contributed to the LLC.

[4658] It did not think to cite cases involving trust-owned insurance on a beneficiary's life, where no incidents of ownership were attributed to the beneficiary. Letter Rulings 9602010 and 9748020. Rev. Rul. 84-179 might also be helpful.

However, the IRS requested some modifications to the LLC's operating agreement. The IRS limited the members' ability to make decisions regarding the LLC's holding of policies. Not mentioned in the ruling is that the operating agreement originally allowed the members voting rights customarily given in a manager-managed LLC, limiting them only to the extent that no member could vote regarding insurance on that member's life. The IRS was concerned that the members could collude in a manner akin to the reciprocal trust doctrine, so it required that the operating agreement preclude members from voting on anything relating to any life insurance policy. Similarly, the IRS required that the operating agreement not expressly authorize amendments by the members, preferring that applicable state law defaults control the situation.

The ruling did not address the effect of the members' assigning their interests in the LLC to others. Although the IRS was not troubled by the prospect of that occurring, it did not wish to consider situations that might arise by reason of such an assignment.

An issue with respect to with a ruling was not sought is the transfer-for-value rules, which make death benefits taxable if policies are transferred in various taxable transactions.[4659] Formation of the LLC should not implicate these rules, because formation is a nontaxable transfer.[4660] Similarly, a Member receiving an increased ownership percentage of a policy due to an increased contribution is also a nontaxable transfer.[4661] In our case, the Members also participated in other LLCs that held rental real estate; because they were partners for income tax purposes, the transfer-for-value rules do not apply to transfers of policies between them.[4662]

II.Q.4.i.iv. Significance of Letter Ruling 200747002

The ruling has other implications. Using a corporate trustee to hold the policies as manager of the LLC provides security that the proceeds will be used as intended. As mentioned, one of the disadvantages of a cross-purchase is that a shareholder's creditors might be able to prevent application of the proceeds. Depending on applicable state law, the insurance being in an LLC might make a charging order the exclusive remedy. A charging order allows creditors to receive any distributions that belong to the debtor but does not allow the creditor to force the LLC to make distributions. The manager's duty to the other members would prevent the proceeds from being distributed without the consent of the deceased shareholder's beneficiaries.

The operating agreement's original restrictions on members' voting rights generally should be sufficient to avoid estate inclusion. The additional restrictions should be placed in the operating agreement only if seeking a Letter Ruling or advising a client who is willing to sacrifice flexibility to be as close as possible to the letter ruling's facts.

Letter Ruling 200747002 is not geared towards a policy with cash values. However, through a split-dollar arrangement, one might carve out the term portion for the LLC and make other arrangements with the cash value.[4663] Although the term portion eventually becomes uneconomic, one could use a variety of estate-planning techniques with the cash value portion before that happens so that, ultimately, the insurance arrangement becomes sustainable.

The ruling also held that Brother's Irrevocable Trust was a grantor trust, in which Brother was treated as owning Brother's Irrevocable Trust's assets for income tax purposes under

[4659] Code § 101(a)(2).
[4660] Code §§ 101(a)(2)(A), 721(a).
[4661] Code § 721(a).
[4662] Code § 101(a)(2)(B).
[4663] See footnote 4352 for a summary of how split-dollar arrangements work.

Code § 678; Sister was similarly treated as the owner of Sister's Irrevocable Trust. This was critically important to allow Brother's Irrevocable Trust and Sister's Irrevocable Trust to own stock in the S corporation. Brother initially had a withdrawal right in Brother's Irrevocable Trust that had since lapsed; the same tool was used for Sister and Sister's Irrevocable Trust. Although such withdrawal rights are usually used to obtain the gift tax annual exclusion, in this case a significant purpose of granting withdrawal rights was to obtain grantor trust status treating the beneficiary as the owner.

The above issues are as far as the ruling was sought to cover. However, this structure has uses far beyond the issues discussed in the ruling.

First, Trusts 2A and 2B were originally funded with modest gifts that they invested in LLCs that used bank financing to buy real estate. These LLCs leased the real estate to the S corporation. The net cash flow from the rental operations would be used to pay the life insurance premiums through the insurance LLC. Thus, the income tax goal of holding real estate in partnerships was married with leveraging gifts to generation-skipping trusts.

Second, Trusts 2A and 2B were ideal for the tactic of selling stock to an irrevocable grantor trust.[4664] For example, Brother could sell S stock to Brother's Irrevocable Trust in exchange for a promissory note. No income tax would result during Brother's life, because Brother is treated for income tax purposes as owning Brother's Irrevocable Trust. If the IRS determined that the stock's value was too high and that therefore Brother made a gift, Brother would pay no gift tax because the gift is an incomplete gift due to Brother's power to appoint the trust's assets at death. If Brother's Irrevocable Trust were thinly funded, Brother and other trusts created by Grantor for Brother could guarantee the promissory note to provide additional economic reality to the sale.

If Brother dies during the term of the note, Sister and BA would use the insurance to buy Brother's Irrevocable Trust's stock, thus providing cash to retire the note to Brother.

If the sale of S stock to Brother's Irrevocable Trust generates cash flow in excess of the note payments, the excess cash could be used to pay premiums through the insurance LLC, allowing Brother's Irrevocable Trust to participate more in the buy-sell than it would have been able to do with just the net rental proceeds.

Note that Brother has access to the excess funds for Brother's support. The excess funds could also be used to help Brother's children when they are no longer legally dependents, without being limited by the annual gift tax exclusion or using Child 2A's applicable exclusion amount.

What if the parties had used a cash value policy subject to a split-dollar arrangement instead of term policies? After Brother's Irrevocable Trust fully repays the note on the sale of stock, it should have plenty of cash flow to repay the split-dollar obligations.

Sister would use the same strategy.

II.Q.4.i.v. Practical Logistics for Life Insurance LLC

The Letter Ruling 200747002 life insurance LLC included the insureds as members, carving out interests in each policy so that no insured had an interest in a policy on his or her own life.

[4664] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

Since the taxpayer's loss in *Huffman*, I have become more focused on the taxpayer's burden of proving facts in any entity subject to Code § 2703.[4665] If Code § 2703 applies,[4666] consider whether policies for one insured should be held in a separate LLC in which the insured is not a member. If that is the case, then the insured's family still needs protection from the death benefit being misused if the members of the LLC fire the manager and put in someone who will do their bidding, as well as vetoing any changes that may divert the death benefit from its intended buy-sell use; given that the insured's family is more akin to a creditor regarding the sale proceeds, consider building in protections for them along the lines of what creditors require as third party beneficiaries described in part II.F.8 Bankruptcy Remote Entities.

Keep in mind that any person who is at least a 5% owner of the LLC would be considered an employee whose notice and consent might be required, as described in part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.[4667] Whether the parties transfer the life insurance to the LLC or the LLC buys original issue insurance, the parties will probably use a notice and consent along the lines of part II.Q.4.g.iii Consent for Owner Who Is Not an Employee. However, the operating agreement might also include notice and consent as a safety valve.[4668]

Often, the operating business will pay the premiums on behalf of the owners – just to make sure it gets done so that the business' succession plan is funded as expected. These payments are accounted for as distributions or compensation to the owners - or a combination. Common logistics include:

- A owns 75% and B owns 25% of Company. Suppose Company is worth $1M. A needs to buy $250K of insurance on B, whereas B needs to buy $750K of insurance on A.

- B needs to buy three times as much life insurance death benefit as does A; however, B receives only one-third (25% divided by 75%) the distributions as A receives.

- If A is older than B is, then the cost of each $1K of death benefit on A will be higher than the cost of each $1K of death benefit on B, further exacerbating the disproportionality of the premium payments.

- If Company treats the premiums as distributions, then B is getting a disproportionate distribution through those payments, so A needs additional cash distributions to make overall distributions (deemed or actual) proportionate.

4665 See parts II.Q.4.h Establishing Estate Tax Values and III.B.7.e Code § 2703 Overview.

4666 See part III.B.7.e Code § 2703 Overview, including the Reg. § 25.2703-1(b)(3) exception in the text preceding and accompanying fn. 7504.

4667 Code § 101(j)(3)(A)(i) applies only if the policy "is owned by a person engaged in a trade or business" (among other requirements). I view a life insurance LLC being engaged characterized as "engaged in a trade or business" to be highly unlikely, in light of the standards in part II.E.1.c.iii.(c) "Trade or Business" in Other Areas of Tax Law. Nevertheless, compliance with the notice and consent process is relatively easy, so I recommend it, given that millions of dollars of income tax may be at issues. However, I would not emphasize filing Form 8925, Report of Employer-Owned Life Insurance Contracts, given that we believe that, as a person not engaged in a trade or business, a life insurance LLC is not required to file and Form 8925 is purely an informational return without harsh penalties.

4668 See fn. fn. 4615, which is found in part II.Q.4.g.i Analysis of Code § 101(j); for an example, see part II.Q.4.g.ii Consent Integrated into Operating Agreement.

- If Company is making huge cash distributions, perhaps the premium payments will be immaterial relative to cash flow, so the make-up distributions to A (or cut-off of cash distributions to B) might not be a big deal.

- In many cases, B is much younger than A, and B will be frustrated at the lack of distributions that B actually takes home.

- So that B does not get frustrated, Company treats as compensation some portion of the premiums allocated to B regarding insurance on A's life. Note that these payments need to be "grossed-up" –additional compensation to pay the income tax on the premium compensation. For example, if $10,000 of premium is treated as compensation to B and B is in the 40% tax bracket, Company needs to pay a $16,667 bonus, of which $10,000 is allocated to premium and $6,667 (which is $16,667 multiplied by 40%) is income tax withholding.[4669] Note that Company (or its owners, if it is taxed as a partnership or S corporation) will get a $16,667 deduction that may save taxes that are more or less than the $6,667 income tax withholding.

If the operating business is a C corporation, it would account for the premium payments as compensation (as an officer or director), because dividends are nondeductible to the company and taxable to the shareholders.

If the operating business is an S corporation, it would account for the premium payments as compensation or as a distribution. Compensation tends to be the more popular choice, in that it can be non-pro rata, but the parties' economic deal might make distributions more attractive, and any temporary timing differences of distributions should not cause problems with the S corporation single class of stock rule;[4670] to avoid problems with the latter, these payments should not be contractually mandated but rather should be an administrative practice.[4671] However, in the Sixth Circuit the corporation might be compelled to treat the economic benefit from a split-dollar arrangement (which may apply if the corporation retains any interest in the policy or its death benefit)[4672] as a distribution.[4673]

When the operating company is taxed as a partnership, it might consider setting up a separate distribution account for premiums paid on behalf of each owner. That way, the distributions can be reconciled more easily against what the life insurance LLC is doing.

II.Q.4.i.vi. Letter Ruling 200947006

The IRS has also ruled that an insured who was a partner in a partnership had no incidents of ownership. In Letter Ruling 200947006, the insured had direct and indirect ownership of a partnership that held a policy on his life.[4674] That partnership and other partnerships (in which

[4669] The gross-up formula is dividing the target compensation by one minus the tax rate. In this example, B's tax rate is 40%, so 100% minus B's 40% tax rate is 60%. Dividing $10,000 by 0.6 results in $16,667.
[4670] See part II.A.2.i.ii Temporary Timing Differences; Other Varying Differences.
[4671] Disproportionate distributions violate the single class of stock rule only if mandated by an agreement in the nature of articles of incorporation, etc. See parts II.A.2.i.iii Disproportionate Distributions (Not Temporary), II.A.2.i.xii Automatic Relief If Governing Provisions Violate Single Class of Stock Rule, and II.A.2.i.xiii Automatic Relief If Disproportionate Distributions Violate Single Class of Stock Rule.
[4672] See generally part II.Q.4.f Split-Dollar Arrangements.
[4673] See text accompanying fns. 4515-4519 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22**.**
[4674] See also Letter Rulings 200948001 and 200949004, which appear to be companion rulings.

the insured had direct or indirect ownership) were beneficiaries. The arrangement was restructured so that the insured had no right to make decisions on behalf of a trust that owned the partnership, and the insured's other direct or indirect interest in the partnership was terminated. The IRS ruled that the insured not only had no incidents of ownership after the transaction but also (to avoid Code § 2035) had no incidents of ownership before the transaction.

II.Q.4.i.vii. Transitioning from Redemption to Cross-Purchase

If the operating business is an entity taxed as a partnership, it can distribute policies to the life insurance LLC as a deemed tax-free distribution to its owner, followed by a deemed tax free contribution to the life insurance LLC.[4675]

If the operating business is an entity taxed as a corporation - C or S, then any distribution will constitute a taxable sale, causing income taxation[4676] and needing a special exception from the transfer-for-value rule to preserve the exclusion from income tax.[4677] Instead of distributing policies, consider having the life insurance LLC rent the death benefit under part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22, which is a subpart of part II.Q.4.f Split-Dollar Arrangements.

Also see generally part II.Q.7.a Corporate Redemption, especially part II.Q.7.a.i Redemption Compared to Cross-Purchase.

II.Q.4.j. Cross-Purchase Using Trusts

Letter Ruling 9328010 involved the following facts:[4678]

> Partners represent that together they own 100% of the stock of Corporation and also own 100% of the interest in Partnership. All Partners are shareholders of Corporation. Both Corporation and Partnership existed prior to the proposed transaction. Partners represent that Corporation owns life insurance policies on the lives of each Partner, with Corporation as the beneficiary of the policies. Currently, Partners and Corporation are party to a redemption agreement, under which upon the death of any shareholder (one of the Partners), Corporation must use the proceeds from the life insurance policy held by Corporation on the life of that deceased shareholder (Partner) to redeem the shares of Corporation owned by the deceased shareholder's (Partner's) estate.
>
> Partners represent that they intend to replace the current agreement with a new redemption agreement, entitled Stock and Partnership Unit Purchase Agreement [hereinafter new agreement], a copy of which is appended to the request for ruling. Under the new agreement, upon the death of a Partner (who is also a shareholder of

[4675] See text accompanying fns. 4386-4388 in part II.Q.4.b.i Transfer for Value Rule Generally regarding certain transfers involving partnerships. Distributions from partnerships generally are tax-free, as described in part II.Q.8.b.i Distribution of Property by a Partnership; and, as described in fn. 5422, a life insurance contract is not targeted by part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). Entering into a partnership is also tax-free generally ; see part II.M.3 Buying into or Forming a Partnership.

[4676] See parts II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders and II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.

[4677] See part II.Q.4.b.i Transfer for Value Rule Generally.

[4678] Letter Rulings 9328012, 9328017, 9328019 and 9328020 appear to be companion rulings.

Corporation), the surviving Partners will be obligated to purchase all shares in Corporation and interests in Partnership held by a deceased Partner's estate. The new agreement provides that Partners are to use the proceeds from a life insurance policy insuring the life of a deceased Partner to facilitate the discharge of the obligations of the surviving Partners to pay for the purchase of the Corporation shares and Partnership interests from the estate of a deceased Partner. In order to effectuate this redemption agreement, Partners have decided to transfer ownership of the life insurance policies as described below.

Initially, Corporation will transfer the existing life insurance policies to Partnership in part payment of annual rent due Partnership from Corporation. Secondly, Partnership will transfer the policies to Partners such that after the transfers, the policies will be owned as follows:

i. The policy on Partner A will be jointly owned by Partners B, C, D, and E, each owning an equal 25% interest in such policy.

ii. The policy on Partner B will be jointly owned by Partners A, C, D, and E, each owning an equal 25% interest in such policy.

iii. The policy on Partner C will be jointly owned by Partners A, B, D, and E, each owning an equal 25% interest in such policy.

iv. The policy on Partner D will be jointly owned by Partners A, B, C, and E, each owning an equal 25% interest in such policy.

v. The policy on Partner E will be jointly owned by Partners A, B, C, and D, each owning an equal 25% interest in such policy.

After these transfers, neither Corporation nor Partnership will have any legal or beneficial interest in the life insurance policies.

Partners further represent that after the above transfer from the Partnership to the Partners, the policies will be transferred from Partners to Trust A, Trust B, Trust C, Trust D, and Trust E (hereinafter the Trusts). Copies of the trust agreements are appended to the request for ruling. Partners represent that each Trust is a grantor trust under sections 671−677 of the Code and that the only asset of each Trust will be a life insurance policy of the life of a partner, who is not a grantor in that trust.

The grantors of each Trust will be Partners that transferred the policy to the Trust; these same Partners will be the only beneficiaries of the Trust. The Trusts will be created as follows:

i. The grantors and beneficiaries of Trust A will be Partners B, C, D, and E; the only asset of Trust A will be the life insurance policy on the life of Partner A, currently owned by Partners B, C, D, and E.

ii. The grantors and beneficiaries of Trust B will be Partners A, C, D, and E; the only asset of Trust B will be the life insurance policy on the life of Partner B, currently owned by Partners A, C, D, and E.

iii. The grantors and beneficiaries of Trust C will be Partners A, B, D, and E; the only asset of Trust C will be the life insurance policy on the life of Partner C, currently owned by Partners A, B, D, and E.

iv. The grantors and beneficiaries of Trust D will be Partners A, B, C, and E; the only asset of Trust D will be the life insurance policy on the life of Partner D, currently owned by Partners A, B, C, and E.

v. The grantors and beneficiaries of Trust E will be Partners A, B, C, and D; the only asset of Trust E will be the life insurance policy on the life of Partner E, currently owned by Partners A, B, C, and D.

> Partners represent that the transfers of the policies from Corporation to Partnership to Partners to Trusts will be completed within one month.
>
> Partners further represent that upon the death of any Partner, the trust agreements of Trusts provides that the trustee of Trust will distribute the proceeds from the life insurance policy to the beneficiaries, grantors, who will then use the proceeds to pay the estate of the deceased Partner for the value of the Partner's interest in Partnership and shares in Corporation. Additionally, upon the death of any Partner, the interest of the deceased Partner's estate in the remaining Trusts will be transferred to the surviving Partners in return for a cash payment equal to the value of the estate's interest in the unmatured policies which are owned by the remaining Trusts.
>
> For example, upon the death of Partner A, the Trustee of Trust A will distribute the proceeds from the life insurance policy on the life of Partner A to the beneficiaries of Trust A, Partners B, C, D, and E; Partners B, C, D, and E will then use the proceeds to pay the estate of Partner A for the value of Partner A's interest in Partnership and shares in Corporation. Additionally, all interests that Partner A has in Trusts B, C, D, and E will be transferred to Partners B, C, D, and E, pursuant to the terms of each Trust. In transferring the interest that Partner A had in the Trusts, the recipients of the interests will be the remaining beneficiaries of each Trust. Thus, as to Trust B, the grantors of Trust B are Partners A, C, D, and E. Partner A's interest in Trust B will be transferred in equal shares to the surviving grantors of Trust B, Partners C, D, and E; Partner B has no interest in Trust B and thus does not receive any of Partner A's interest therein. Similarly, as to Trust C, Partner A's interest will be transferred in equal shares to the surviving grantors, Partners B, D, and E. Similar transfers occur with respect to Partner A's interests in Trusts D and E. In exchange, the estate of Partner A will receive a cash payment equal to the value of those interests.

After citing then-Reg. § 1.101-1(b)(3)(ii) for the proposition that, "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 life insurance policy proceeds paid by reason of death of the insured from gross income under section 101(a)(1) of the Code," Letter Ruling 9328010 reasoned:

> Under the Taxpayers' facts, there are two separate transactions; the first is a series of contemporaneous transfers from Corporation to Partnership to certain Partners to certain Trusts and the second is a set of singular transfers that occur upon the death of a Partner when the interests in Trusts owning unmatured life insurance policies are transferred to other Partners.

With respect to the first series of transfers, pursuant to section 1.101-1(b)(3)(ii) of the regulations, if the last transfer of the life insurance policies are to partners of the insureds, then the exclusion from income of the life insurance proceeds provided by section 101(a)(1) of the Code applies. The Taxpayers' representations indicate that the last transfers of the policies are to the Trusts. Under Rev. Rul. 74-76, when the grantors, Partners, contribute the life insurance policies to each Trust, there is no change in beneficial ownership of the policies; thus, the Partners who owned the policies prior to transfer to the Trusts continue to own them after the transfer. After the transfers, the Trusts are the legal owners of the policies and the grantors have beneficial ownership. In each Trust, the grantors are partners to the insureds. Thus, the final transfer in the first transaction is to partners of the insureds under section 101(a)(2)(B) of the Code.

In the second transaction, upon the death of each Partner, the interest that the deceased Partner's estate has in the Trusts will be transferred to the surviving grantor Partners for each Trust. Since the trusts are grantor trusts and the only asset in each trust are unmatured life insurance policies, the estate of the deceased Partner is transferring interests in unmatured life insurance policies to persons who are partners of the insureds. When Partner A dies, any interest that Partner A had in Trust B is transferred to the other grantors of Trust B. The only asset of Trust B is a life insurance policy on the life of Partner B; at the death of Partner A, the surviving grantors of Trust B are Partners C, D, and E. Since Partners C, D, and E are partners in Partnership with Partner B, the insured under the life insurance policy in Trust B, the interest in Trust B is being transferred to partners of the insured. Thus, upon the death of a Partner, the interests which that deceased Partner's estate had in the life insurance policies on the remaining Partners, which are the sole assets of the Trusts, are transferred to partners of the insured under section 101(a)(2)(B) of the Code.

Letter Ruling 9328010 concluded:

1. The transfer of the life insurance policies from Corporation to Partnership to Partners is a "transfer to a partner of the insured" within the meaning of section 101(a)(2)(B) of the Code and therefore not subject to the "transfer-for-value" limitation of section 101(a)(2).

2. The transfer of the life insurance policies from Partners to Trusts is not a "transfer for a valuable consideration" within the meaning of section 101(a)(2).

3. The transfer of a deceased Partner's beneficial interest in Trusts to the other surviving Partners is a "transfer to a partner of the insured" within the meaning of section 101(a)(2)(B) and therefore not subject to the "transfer-for-value" limitation of section 101(a)(2).

This strategy may work well if the ownership structure of A, B, C, D, and E remains unchanged perpetually. Unfortunately, that is not realistic, and a life insurance LLC provides a more nimble arrangement. If parties want to use irrevocable trusts, the trusts can own the life insurance LLC.