Planning for Business Owners and Trusts in Light of Changing Income Tax Rates

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

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Planning for Business Owners and Trusts in Light of Changing Income Tax Rates

by Steven B. Gorin*

I. Introduction

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

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

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

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.

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II.E. Recommended Structure for Entities

II.E.1. Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities

Below is a comparison of annual federal and state income tax burdens when the owners are in the highest or in a modest tax bracket, based on calculations shown in Parts II.E.1.a Taxes Imposed on C Corporations and II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships. The assumptions made in putting together the chart can be criticized, but hopefully reviewing them helps one understand the post-2017 paradigm.

Moderate State Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S Corporation, Partnership, or Sole Proprietorship (Pass-Through)	34.6%-45.8%	27.4%-46.2%

Note, however, that distributing less than 100% of corporate net income after tax does not reflect the true tax cost, because additional tax will often be incurred when extracting the earnings later through a dividend or sale. For a discussion of the extent to which that is true and how choice of entity affects exit strategies, see part II.E.2.a Transferring the Business.

Also consider that the excess of pass-through income tax rates over corporate rates is at an all-time high.

A partnership or S corporation that does business in many states incurs extra state compliance obligations, because states often require withholding on nonresident owners, require all owners to file in all of those states, or require both. Also note that individuals or trusts owning pass-through businesses will be able to deduct little or no of the state income tax on their business income, whereas C corporations are not subject to such limitations.[690]

For a start-up entity, consider that most businesses lose money initially, and some never get into the black. An LLC taxed as a sole proprietorship or partnership is a much better vehicle for deducting losses[691] than is an S corporation[692] or C corporation.[693] If one is enamored with corporate income taxation, one might start as an LLC and then contribute the LLC to a corporation when one becomes sufficiently profitable to save taxes.[694] The disadvantage of such an approach occurs when the owner is in a low tax bracket, so that losses provide little, if any, benefit; in that case, having the C corporation carry forward its losses to offset them against income that would otherwise have been taxed at a higher rate – and relying on Code § 1244 for ordinary loss treatment if the business is unsuccessful[695] – might be of greater benefit.

Incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[696] However, C corporations provide better fringe benefits.[697]

II.E.1.a. Taxes Imposed on C Corporations

For taxable years beginning after December 31, 2017, all C corporations pay tax at a flat 21% rate, unless some industry-specific exclusions, such as those for insurance companies, apply.[698] However, if a C corporation receives a dividend from another corporation, only part of

[690] See text accompanying fn 20 in part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment.
[691] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.4.e Basis Limitations for Partners in a Partnership.
[692] See part II.A.2 S Corporation.
[693] See parts II.G.4.b C Corporations: Losses Incurred by Business, Owner, or Employee and II.G.4.f Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses.
[694] Although one could just "check the box" by filing Form 8832 or 2553, as the case may be, contributing an interest in the LLC sets one up for an ideal entity structure and avoids possible (remote) self-employment tax issues. See parts II.E Recommended Structure for Entities and II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, respectively. For entity conversion issues, see part II.P.3 Conversions.
[695] See parts II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 and II.J.11.b Code § 1244 Treatment Not Available for Trusts.
[696] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.
[697] See part II.P.2 C Corporation Advantage Regarding Fringe Benefits.
[698] Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

> (1) section 594 (relating to mutual savings banks conducting life insurance business),
> (2) subchapter L (sec. 801 and following, relating to insurance companies), or
> (3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

that dividend is taxed,[699] reducing the effective tax rate to 10.5% for dividends from unrelated companies or zero or 7.35% for dividends from affiliates.

Biden would raise the top corporate income tax rate to 28% and increase the top income tax rate on dividends to 39.6% (before 3.8% net investment income tax).

In addition to taxes on annual operations, consider:

- Dividends to shareholders, which are distributions out of a corporation's current or accumulated earnings and profits, are subject to regular tax at capital gain rates[700] (if qualified dividends)[701] and the 3.8% tax on net investment income.[702] However, Biden proposed that high-income taxpayers' long-term capital gains would be taxed at 39.6% instead of 20%.

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[699] See fns. 9-13 in part II.A.1.a C Corporations Generally.

[700] Code §§ 1(h)(3), 1(h)(11)(A).

[701] Code § 1(h)(11)(B) provides the following parameters for "qualified dividend income":

(i) *In general*. The term "qualified dividend income" means dividends received during the taxable year from-
  (I) domestic corporations, and
  (II) qualified foreign corporations.

(ii) *Certain dividends excluded*. Such term shall not include-
  (I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,
  (II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and
  (III) any dividend described in section 404(k).

(iii) *Coordination with section 246(c)*. Such term shall not include any dividend on any share of stock-
  (I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period"), or
  (II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Elaborating on Code § 1(h)(11)(B)(i)(II), Code § 1(h)(11)(C) provides rules for qualified foreign corporations.

Code § 1(h)(11)(D) provides special rules:

(i) *Amounts taken into account as investment income.* Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B). [My note: This relates to income against which investment interest may be deducted. See part II.G.21.a Limitations on Deducting Business Interest Expense, which mentions in passing investment interest expense.]

(ii) *Extraordinary dividends*. If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059(c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.

(iii) *Treatment of dividends from regulated investment companies and real estate investment trusts*. A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

[702] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

- A corporation that does not pay dividends may become subject to the 20% accumulated earnings tax or personal holding company income tax. See part 0 No distributions under Biden's plan:

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200

So, effective tax rates under current law are 55.8% distributing all earnings, 42.8% distributing half of the earnings, and 29.8% distributing none of the earnings.

Effective tax rates under the Biden plan are 72.6% distributing all earnings, 54.7% distributing half of the earnings, and 36.8% distributing none of the earnings.

- Incentives to Declare Dividends.

- A corporation that distributes property to its shareholders generally is subject to tax on the excess of value over basis (but cannot deduct a loss). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

II.E.1.a.i. Corporate Tax Rates in Moderate Tax States

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals. The individual in a top bracket is assumed taxed at a rate of 48.4%, consisting of 39.6% capital gain tax, 3.8% net investment income tax, and 5% state income tax. The individual in a modest bracket is assumed taxed at a rate of 20%, consisting of 15% capital gain tax, no net investment income tax, and 5% state income tax.

Distributing 100% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Income Taxes at 28.8% or 20%	-21,312	-14,800
Net Cash to Owner	$52,688	$59,200

Note that the tax rates above seem somewhat high – 47.3% or 40.8%, depending on whether the shareholder is in a high or modest bracket. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[703] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[704]

Here is the same chart under Biden, with federal corporate tax rate increased from 21% to 28% and the top federal income tax rate on dividends increased from 20% to 39.6%:

Biden Plan		
Distributing 100% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-33,000	-33,000
Net Income after Income Tax	$67,000	$67,000
Income Taxes at 48.4% or 20%	-32,428	-13,400
Net Cash to Owner	$34,572	$53,600

[703] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, text accompanying fn 708-710. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2.5%-13.3%.
[704] See fns. 89-91 in part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax.

Returning to current law:

Distributing 50% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Distribution to Owner	$37,000	$37,000
Income Taxes at 28.8% or 20%	-10,656	-7,400
Net Cash to Owner	$26,344	$29,600
Corporate Cash Plus Shareholder Cash	$63,344	$66,600

Here is the same chart under Biden, with federal corporate tax rate increased from 21% to 28% and the top federal income tax rate on dividends increased from 20% to 39.6%:

Biden Plan		
Distributing 50% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-33,000	-33,000
Net Income after Income Tax	$67,000	$67,000
Distribution to Owner	$33,500	$33,500
Income Taxes at 48.4% or 20%	-16,214	-6,700
Net Cash to Owner	$17,286	$26,800
Corporate Cash Plus Shareholder Cash	$50,786	$60,300

Returning to current law:

Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-26,000
Net Income after Income Tax	$74,000

Here is the same chart under Biden, with federal corporate tax rate increased from 21% to 28%:

Biden Plan	
Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-33,000
Net Income after Income Tax	$67,000

II.E.1.a.ii. Corporate Tax Rates in California

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in California, which imposed an 8.84% corporate tax rate. The individual in a top bracket is assumed taxed at a rate of 37.1%, consisting of 20% capital gain tax, 3.8% net investment income tax, and 13.3% state income tax.

Distributing 100% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200
Income Taxes at 37.1%	-26,044
Net Cash to Owner	$44,156

Note that the effective annual tax rate above seems somewhat high at just under 56%. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA

combines to add tax equal to 2.5%-13.3%.[705] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[706]

Biden would raise the top corporate income tax rate to 28% and increase the top income tax rate on dividends to 39.6% (before 3.8% net investment income tax). This would increase the top corporate rate in California to approximately 36.8% (28% + 8.84%) and the top individual rate for dividends of 56.7%, consisting of 39.6% capital gain tax, 3.8% net investment income tax, and 13.3% state income tax.

Biden Plan	
Distributing 100% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200
Income Taxes at 56.7%	-35,834
Net Cash to Owner	$27,366

Here's distributing half of the profits:

Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200
Distribution to Owner	$35,100
Income Taxes at 37.1%	-13,022
Net Cash to Owner	$22,078
Corporate Cash Plus Shareholder Cash	$57,178

[705] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, text accompanying fn 708-710. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2%-13%.
[706] See fns. 89-91 in part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax.

Distributing half under Biden's plan:

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200
Distribution to Owner	$31,600
Income Taxes at 56.7%	-17,917
Net Cash to Owner	$13,683
Corporate Cash Plus Shareholder Cash	$45,283

No distributions under current law:

Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200

No distributions under Biden's plan:

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200

So, effective tax rates under current law are 55.8% distributing all earnings, 42.8% distributing half of the earnings, and 29.8% distributing none of the earnings.

Effective tax rates under the Biden plan are 72.6% distributing all earnings, 54.7% distributing half of the earnings, and 36.8% distributing none of the earnings.

II.E.1.a.iii. Incentives to Declare Dividends

Many years ago, Congress incentivized corporations to declare dividends, through the imposition of two taxes:

- Personal holding company tax. A personal holding company is taxed on 20% of its undistributed personal holding company income. See part II.A.1.e Personal Holding Company Tax.

- Accumulated earnings tax. Generally, a C corporation that accumulates funds could be subject to the 20% accumulated earnings tax on its excess undistributed accumulated earnings and profits. The corporation needs to articulate specific reasons why its needs to reinvest its earnings. For details, see part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax. This tax does not apply to personal holding companies (as used in the preceding bullet point). If the company not a personal holding company but is a mere holding or investment company, the tax kicks in if undistributed earnings exceed $125,000.[707]

Each of these taxes can be avoided by paying sufficient dividends. The corporation may manage these taxes by actual or deemed dividends; see the relevant tax for rules on the extent to which this is permitted and how to do it.

II.E.1.b. Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships

Generally, S corporations and partnerships do not pay entity-level income tax; instead, their owners pay tax on their distributive share of the entity's income. However, some state or local governments do impose an entity-level tax, which may be in addition to imposing income tax on the owners' distributive share of the entity's income.

Tax reform in 2017 introduced a deduction of up to 20% of business earnings. See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

An owner of a partnership or sole proprietorship also generally pays tax self-employment ("SE") tax on income from a trade or business, subject to various exceptions; see part II.L Self-Employment Tax (FICA). SE tax is 15.3% OASDI and Medicare taxes until the taxpayer reaches the taxable wage base ($137,700 in 2020 and $142,800 in 2021),[708] then is 2.9% Medicare tax until it reaches 3.8%, when the supplemental Medicare tax (employee's portion) kicks in.[709] The employer's portion of SE tax, which is 7.65% up to the taxable wage base and 1.45% thereafter, is deductible in determining adjusted gross income (not as an itemized deduction).[710]

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[707] See fn 4605 in part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.

[708] See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount.

[709] See fns 3264-3266 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

[710] Code § 164(f), "Deduction for one-half of self-employment taxes," provides:

> (1) *In general*. In the case of an individual, in addition to the taxes described in subsection (a), there shall be allowed as a deduction for the taxable year an amount equal to one-half of the taxes imposed by section 1401 (other than the taxes imposed by section 1401(b)(2)) for such taxable year.
>
> (2) *Deduction treated as attributable to trade or business*. For purposes of this chapter, the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services by the taxpayer as an employee.

An owner of an S corporation or partnership may pay the 3.8% tax on net investment income ("NII"); see part II.I 3.8% Tax on Excess Net Investment Income (NII). SE income is excluded from NII.[711] The deduction for the employer's share of SE tax makes SE tax preferable to NII tax, except to the extent that the income would be below the taxable wage base.

To the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[712] or stock[713] increases. Generally, an owner can withdraw the earnings tax-free, merely reducing basis in the owner's partnership interest or stock. See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.7.b Redemptions or Distributions Involving S Corporations. However, an S corporation that distributes property triggers tax on the gain,[714] which gain is taxed at its shareholders' respective income tax rates and in many cases does not qualify for favorable capital gain rates.[715]

Let's examine the effects of earning $100,000 taxable income inside the entity, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals:

An individual in a top bracket might be taxed at a rate of 34.6%-45.8%, consisting of:

- 29.6%-37% ordinary income tax (depending on whether the Code § 199A 20% deduction is available)
- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and
- 5% state income tax.

Biden wants to raise the top bracket from 37% to 39.6% and disallow the Code § 199A deduction for such individuals. An individual in a top bracket might be taxed at a rate of 44.6%-48.4%, consisting of:

- 39.6% ordinary income tax,
- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and
- 5% state income tax.

An individual in a modest bracket might be taxed at a rate of 27.4%-46.2%, consisting of:

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[711] As to SE income being excluded from NII, see fn 2204 in part II.I.5 What is Net Investment Income Generally.
[712] Code § 705.
[713] Code § 1367.
[714] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[715] See parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

- 22.4%-28% ordinary income tax (depending on whether the Code § 199A 20% deduction is available, and the wage limitations[716] and restrictions on types of businesses do not apply to modest income taxpayers)

- zero-13.2% SE tax income tax (after considering the deduction for one-half of SE tax)

- 5% state income tax.

In California, the rates are as follows, as described in part II.Q.1.a.ii California Scenarios:

S corporation income rate:	29.6%-37%	federal
	13.3%	state individual
	1.5%	state entity
	zero-3.8%	NII tax
	44.4%-55.6%	
Partnership income rate:	29.6%-37%	federal
	13.3%	state
	zero-3.8%	NII or SE tax
	42.9%-54.1%	

II.E.1.g. Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation

As mentioned earlier:

- Dividends a C corporation receives from another domestic C corporation are subjected to federal income tax of no more than 10.5%.[982]

- Taxable interest and capital gains are subjected to 21% federal income tax.[983]

Contrast this to a taxpayer in the highest tax bracket, who is subjected to federal income tax of:

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[716] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[982] See part II.E.1.a Taxes Imposed on C Corporations, especially the text accompanying fn 699, referring to fns. 9-13 in part II.A.1.a C Corporations Generally.

[983] Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

- 23.8% on qualified dividends[984] and net long-term capital gains, considering the 20% top capital gain rate[985] and 3.8% net investment income tax.[986]

- 40.8% on taxable interest income, nonqualified dividends, and net short-term capital gains, considering the 37% top ordinary income tax rate[987] and 3.8% net investment income tax.[988]

- For any taxable year beginning after December 31, 2017 and before January 1, 2026, individuals cannot deduct investment management fees relating to managing their own marketable securities.[989] This disallowance does not apply to C corporations, because C corporation deductions are not itemized deductions.

However, the chart in part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, which also considers moderate state income tax, illustrates that the C corporation advantage quickly dissipates if the corporation makes distributions.

The personal holding company tax or accumulated earnings tax may essentially force a corporation to declare dividends – especially if the corporation accumulates more than $125,000 in earnings.[990]

Eventually, however, income will need to be distributed so that the owner actually benefits from the investment return, imposing dividend tax at that time and undermining – to some extent (small or large) the advantage of C corporation income tax savings. Another option, which can make this strategy much more tenable, is: the investor grows the assets at smaller income tax rates, increasing future annual income, then converts to an S corporation and distributes current income while leaving prior years' income in the corporation to grow; see part II.E.2.c Converting a C Corporation to an S Corporation, which also includes warnings regarding investment mix after making the S election.

Harvesting the accumulated income by simply selling the C corporation does not produce good results. See part II.E.2 Comparing Exit Strategies from C Corporations and Pass-Through Entities.

Finally, if one decides to use a corporation to hold investments, consider what happens when one passes them to one's children or other various beneficiaries. A similar but perhaps more predictable termination concern applies to trusts. A corporation that invests in portfolio assets cannot divide without triggering income tax. One might consider creating a few corporations (in the case of a trust, one for each remainderman). These corporations then invest in a partnership, which can divide without triggering income tax. That way, each corporation can receive a mix of assets more along the lines of the beneficiary's preferences. For more details, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made), which describes the corporate division issue and a solution.

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984 See part II.E.1.a Taxes Imposed on C Corporations, fns 700-701 and text accompanying them.
985 Code § 1(h)(1), with exceptions under Code § 1(h)(3)-(8) for depreciation recapture, collectibles and Code § 1202 gain taxed as a capital gain at 28%
986 See part II.I 3.8% Tax on Excess Net Investment Income (NII).
987 Code § 1(j), for any taxable year beginning after December 31, 2017, and before January 1, 2026.
988 See part II.I 3.8% Tax on Excess Net Investment Income (NII).
989 Code § 67(g).
990 See text accompanying and preceding fn 707 in part II.E.1.a Taxes Imposed on C Corporations.

I cannot emphasize enough the need to consider an exit strategy. Political winds change over time, and it is very likely that at some point Congress will increase corporate taxes to bring them closer to individual rates. Beware getting into a structure that has costly exit steps and then being stuck there because of that high exit tax. Consider that the Tax Reform Act of 1986 taxed all income, including long-term capital gains, at a top rate of 28%, and the paradigm before 2017 tax reform was very different. The paradigm from 2017 tax reform will change, whether by creeping as the 1986 one did or by dramatic changes needed to reduce the exploding national debt or pay for Medicare or Social Security.

II.E.1.h. Effect of 2017 Tax Reform on Debt-Equity Structure

See part II.G.21.a Limitations on Deducting Business Interest Expense.

Business interest deduction limitations vary by industry.

Businesses with average annual gross receipts of no more than $ 25 million are exempt from this limitation.[991]

II.E.1.i. Conducting Businesses in Different Entities to Facilitate Using the Code § 199A Deduction

Each separate trade or business applies the Code § 199A separately,[992] which may at first glance seem to make shifting operations around meaningless. However, each business activity may have, within the same entity, one or more sets of functions that support that activity, which functions might themselves be viewed as a separate business if conducted in that manner.

A prime example is real estate used in a business. Suppose a law partnership owned its own real estate. If a partner's income is too high, her partnership income would not generate a Code § 199A deduction, because the income is derived from a specific service business.[993] The benefit of owning the real estate is subsumed in the disqualified income. However, if instead the real estate were owned by a separate LLC that was the landlord, the real estate could generate qualified business income (QBI) if the landlord undertook sufficient activity to qualify it as a trade or business; see part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.

Unlike real estate, equipment leasing almost automatically qualifies as a trade or business, according to cases and rulings in the self-employment tax and unrelated business income tax areas.[994] So consider forming a separate equipment leasing venture that services the equipment, with the services perhaps not needed to qualify as a business but helpful to prevent the wage limitation from reducing the Code § 199A deduction.[995] To avoid self-employment tax, be sure to make the venture be a limited partnership with an S corporation general partner or an S corporation; see parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons, II.E.6 Recommended Partnership Structure – Flowchart and II.E.7 Migrating into Partnership Structure (with the latter not as important because a new leasing venture could be started for new equipment). Also, as the Code § 199A deduction approaches its termination, consider part II.E.1.c.ix QBI and Effectively Connected Income.

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[991] See text accompanying fns 1761-1762.
[992] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.
[993] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, fn 819.
[994] See part II.L.2.a.ii Rental Exception to SE Tax, fns 3306-3310.
[995] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

If a professional service firm also sells goods, consider separating the sale of goods from the provision of services. Depending on how the government approaches classifying trades or business as separate,[996] a separate entity may not be needed.

II.E.2. Comparing Exit Strategies from C Corporations and Pass-Through Entities

II.E.2.a. Transferring the Business

Part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis shows that, when doing a seller-financed sale of a business, such as to key employees, other owners, or family members, the value of a business attributable to goodwill can be transferred much more tax-efficiently when using a partnership compared to a C corporation or an S corporation. Part or all of these dynamics can be replicated in other transactions.

A shareholder's stock's basis does not increase as a result of a C corporation's reinvested income. However, part or all of the gain on the sale of original issue stock in a qualified corporation that runs a qualified business is excluded from income. See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, explaining Code § 1202.

However, to the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[997] or stock[998] increases. Thus, the gain on sale usually is much lower when selling a partnership interest or S corporation stock than when selling C corporation stock.

S corporations and partnerships are ideal candidates for estate planning transfers using irrevocable grantor trusts. See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text preceding fn 6292. When the pass-through entity makes distributions to pay its owners' taxes, the irrevocable grantor trust that bought the stock or partnership interest uses those distributions to pay down the note owed to seller, and the seller uses this to pay taxes. Thus, tax distributions are used to build equity in the purchasing irrevocable grantor trust. Contrast this with C corporations, where the corporation pays taxes directly to the government, and any distributions are subject to double taxation. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, using the scenario of a C corporation distributing all of its earnings to its shareholders.

Also, gain on the sale of C corporation stock is subject to the 3.8% tax on net investment income.[999] Gain on the sale of an S corporation or partnership that conducts a trade or business may be largely excluded from that tax when the owner sufficiently participates.[1000]

Furthermore, when an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[1001]

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[996] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.
[997] Code § 705.
[998] Code § 1367.
[999] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[1000] See part II.I.8 Application of 3.8% Tax to Business Income.
[1001] See part II.H.2 Basis Step-Up Issues.

Part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons describes more reasons why I tend to prefer partnerships over S corporations and S corporations over C corporations.

II.E.2.b. Converting from S Corporation to C Corporation

See parts II.A.2.k Terminating an S Election and II.P.3.d Conversion from S Corporation to C Corporation for short-term planning. Ideas include:

- A conversion may be taxable, with the main issue being that an S corporation that was on the cash method that may be required to convert to the accrual method.

- Additional steps may be needed to preserve or distribute the S corporation's accumulated adjustment account (which generally lets S corporations distribute its reinvested taxable earnings later without taxing it shareholders – see part II.Q.7.b Redemptions or Distributions Involving S Corporations). Note that, if the corporation distributes a note before converting, interest income on the note will be taxable at its shareholders' full ordinary income rates and subject to net investment income tax, which together combine to impose a 40.8% federal tax rate, whereas the corporation may receive (see part II.G.21.a Limitations on Deducting Business Interest Expense) a deduction at a 21% federal rate.

However, one always needs to consider what if that decision needs to be reversed when a new Congress changes the income tax paradigm. See parts II.P.3.b Conversion from C Corporation to S Corporation and II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.

Generally, I recommend forming an S corporation parent and then converting the original corporation to a C corporation, for the reasons and using the method described in fns 3834-3842 in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation and at the end of part II.P.3.b.v, which in a nutshell include (see part II.P.3.b.v for details):

- Preserving the corporation's AAA in case it converts back to being an S corporation.

- Avoiding (so it appears) having to wait 5 years before converting back to being an S corporation.[1002]

- Potentially qualifying for the benefits described in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, which does not apply to former S corporations but does apply to C corporation subsidiaries of S corporations.

- Avoiding double tax on assets with value in excess of basis when sold within the C corporation (to the extent later distributed) or after being sold within 5 years after converting from c corporation back to S corporation again.

However, the strategy of distributing a note before converting might trigger tax; see fns 3840-3841 in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.

[1002] See fns 202-204 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

II.E.2.c. Converting a C Corporation to an S Corporation

A C corporation that revoked its S election must wait 5 years to convert back to an S corporation. See part II.A.2.k Terminating an S Election.

See part II.P.3.b Conversion from C Corporation to S Corporation, including II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation. Issues discussed there include the following:

- Generally, an asset sold within 5 years after converting from a C corporation to an S corporation will be taxed at the entity level and again to the shareholders. See part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374. Therefore, before converting, one might sell assets that are likely to sold within 5 years. If the taxpayer uses the cash receipts and disbursements method of accounting, consider switching to accrual before converting, so that accounts receivable do not get hit with this tax.

- Although an S corporation that has accumulated earnings and profits from when it was a C corporation cannot have excess passive investment income, that issue is easily managed through the corporation's investment mix – if one considers the issue and plans for it; investment mix may not need to be managed if the corporation is a partner in an active business that has substantial gross receipts (which is tested rather than the partnership's profits). See part II.P.3.b.iii Excess Passive Investment Income, especially fns 3809-3812.

- Also, an S corporation that has accumulated earnings and profits from when it was a C corporation should not invest in tax-exempt investments, the income from which does not generate AAA and therefore may trigger a taxable dividend when distributed. See part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

- If the corporation maintains an inventory, converting from a C corporation to an S corporation may incur tax. See part II.P.3.b.i LIFO Recapture.

II.E.3. Recommended Structure for Start-Ups

The structure should start as a simple one and then, when the entity is making a lot money, would be transitioned to a more complex structure. For long-term reasons why an entity taxed as a sole proprietorship or partnership makes sense, see part II.E.5.a Strategic Income Tax Benefits of Recommended Structure.

Consider starting with an LLC. Start-up businesses often lose money initially, and an LLC taxed as a sole proprietorship or partnership facilitate loss deductions better than other entities[1003] (although deducting start-up losses might not always generate the best result).[1004] Also, often

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[1003] See part II.G.4 Limitations on Losses.

[1004] If the owner is in a lower bracket in start-up years than in later years, losses might best be deferred, if possible. A variation of this idea is in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. If deferring losses is expected to be particularly beneficial, consider:

- If loans are bank-financed, an S corporation can easily ensure that its owners' distributive share of losses be suspended due to basis limitations until the S corporation becomes profitable. See part II.G.4.d.ii.(a) Limitations on Using Debt to Deduct S Corporation Losses.

owners of closely-held businesses operate with a high degree of informality, and owners of corporations can get into trouble by taking money out without documenting compensation or documenting loans;[1005] contrast that to an LLC that for income tax purposes is either disregarded entity or a partnership,[1006] in which case distributions are either disregarded or generally nontaxable.[1007]

A business with owners that work more than 100 but not more than 500 hours per year might want to move its real estate into the desired structure to avoid the 3.8% net investment income tax on the rental income (because the rental income and expense are disregarded for income tax purposes, being in the same umbrella as the operating business) or on the sale of the rental property. For example, a parent LLC might own an operating LLC and a real estate LLC. See parts II.I.8.c.i If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income, II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax, and II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

However, deducting start-up losses may not be desirable, because the owner is in a lower tax bracket now and expects not to be in a low tax bracket in the future. See part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. In that case, consider using an entity taxed as an S corporation, with the owners guaranteeing loans by third parties but not investing or lending a lot of money themselves. If that, too, generates more losses than desirable, then try a C corporation, which will just roll forward the losses. When using a C corporation or an S corporation, consider planning to qualify for the requirements of part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 (which is not available to trusts).[1008] Beware, however, that using either kind of corporation can make getting into an ideal long-term structure more difficult, because one needs to avoid triggering taxation on a deemed distribution of assets. See part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure. Often a trigger for moving a corporation into the structure is the desire to avoid capital gain tax on the seller-financed sale of the business, which often makes the costs of transition worthwhile if the business has significant goodwill. See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.

When the business starts making money but only enough to pay owner compensation and equipment that is expensed immediately, no additional self-employment tax is due relative to if the entity were a corporation paying compensation to its owners. Furthermore, if the business is

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- A start-up C corporation's losses are simply carried forward and deducted against its later income. See part II.G.4.l.ii Net Operating Loss Deduction. In case the C corporation doesn't succeed, certain start-up documentation can generate ordinary loss (instead of capital loss) treatment when the stock becomes worthless. See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244, subject to part II.J.11.b Code § 1244 Treatment Not Available for Trusts. The timing and documentation (including initial documentation in the case of a loan) of a worthless stock or bad debt deduction can be tricky. See part II.G.4.b C Corporations: Losses Incurred by Business, Owner, or Employee, especially fns. 1150-1151 (stock) and 1153-1155 (loans).

[1005] Such payments are potentially taxable distributions to shareholders; see the text accompanying fns. 4552-4553 in part II.Q.7 Exiting from or Dividing a Corporation. The IRS attacks distributions from S corporations, asserting (often successfully) that they are disguised compensation (and perhaps assessing penalties as well); see part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax, especially fns. 83-84.

[1006] See part II.B Limited Liability Company (LLC).

[1007] See part II.Q.8.b.i Distribution of Property by a Partnership.

[1008] See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

investing profits in equipment, etc., generous write-offs are available.[1009] However, note that wages paid by an S corporation may provide a higher Code § 199A deduction relative to compensation paid to a partner, so consider this corporate advantage.[1010]

Then, when the client is ready for the ideal entity (for example, when self-employment tax on reinvested earnings becomes a significant number), the client can simply assign the LLC to the limited partnership described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart; see part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure. However, the client might express a preference in the long-run to use part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. If so, the client might want to start with that structure instead of starting with an LLC. If one starts with an entity taxed as an S or C corporation instead of an LLC, then the presence of non-compete agreements would make migration to a partnership structure less effective, because the value of the goodwill at the time of the migration would remain inside the corporation.

Suppose that one concludes that a C corporation would be ideal. Starting with an LLC taxed as a partnership and then converting to a C corporation the earlier of five years before a sale is anticipated or shortly before its gross assets reach $50 million might be the most tax-efficient approach.[1011]

Whether or not one likes the above recommendations, consider asset protection with a business' net profits. An entity's creditors' claims take priority over distributions to owners. If an entity distributes to its owners any profits not needed to keep the entity fiscally responsible, generally those assets will not be subjected to the claims of the entity's future creditors. For tax purposes, investments are best kept outside the entity, particularly for a C or an S corporation,[1012] but also, to a certain but more limited extent, for a partnership.[1013] The owners might consider loaning the distributions back to the entity, becoming creditors, rather than owners, to that extent. The owners might also consider forming an LLC taxed as a partnership to hold any distributions that they neither loan to the company nor keep for personal purposes, viewing the LLC as a source for funding future capital projects or exit strategies or perhaps for providing or securing a line of credit

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[1009] See part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.

[1010] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[1011] See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, especially parts II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold and II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (particularly the text accompanying fns. 5057-5065).

[1012] Any distributions of appreciated assets trigger corporate-level income tax, whether paid by the corporation (C corporation) or shareholders (S corporation). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Note also that S corporations that have accumulated earnings and profits from prior periods as an S corporation might want to avoid investments that generate tax-free income; see part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

[1013] See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). Such distributions have more potential to trigger tax than do distributions of other assets, but tax can be avoided with careful planning.

for the business;[1014] however, S corporations might want to avoid any formal requirement in their governing documents that distributions be made to such an LLC.[1015]

II.E.4. Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure

In part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, we learned that:

- To the extent that a C corporation reinvests profits, it is more tax-efficient from the perspective of annual income from operations.
- To the extent that it distributes profits, it is not more tax-efficient.

Given that pass-through entities tend to have superior exit strategies,[1016] the portion of the business that distributes profits should be in a pass-through entity.

One might also consider holding any new equipment in an LLC and leasing it to the C corporation. Bonus depreciation would provide an immediate benefit,[1017] and any inside basis step-up that occurs on the death of, or other transfer by,[1018] an owner may reduce or eliminate depreciation recapture. Then, when a sale of the business is contemplated, the LLC might be contributed to the C corporation so that a later asset sale would be taxed at lower corporate rates, which contribution may work out with little problem or may raise too many issues to be practical.[1019]

Consider forming a limited partnership owned by a C corporation and a pass-through entity, with ownership based on the desired long-term goal for distributions:

[1014] If there is a risk that the corporation will have losses but the shareholders' basis will be insufficient to deduct those losses, then the LLC should loan the funds to its members who should then lend them to the corporation. See part II.G.4.d.ii Using Debt to Deduct S Corporation Losses, which is part of part II.G.4.d Basis Limitation for Shareholders in an S Corporation. Presumably, if the loan from the LLC to the corporation is already in place, the LLC could simply distribute the loan to its members. See fn. 1180 in part II.G.4.d.ii Using Debt to Deduct S Corporation Losses.

[1015] A partnership is not an eligible shareholder of an S corporation; see part II.A.2.f Shareholders Eligible to Hold S Corporation Stock. Therefore, one might consider avoiding any distribution arrangements that might make a partnership appear to be a shareholder. However, distribution arrangements that are not baked into the governing documents do not count for determining whether a second class of stock exists (see part II.A.2.i.iii Disproportionate Distributions, and within that see fn. 262 for what constitutes governing documents and the effect, if any, given to certain arrangements), so presumably they would not count as creating a shareholder relationship. Although I have not seen anything directly on point, presumably an S corporation can contribute to a partnership in exchange for a partnership interest and then distribute that partnership interest to its shareholders; the parties would have substantial authority for not applying undesirable valuation discounts to that distribution – see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders for general rules, fn. 4855 for authority for no valuation discounts, and part II.Q.7.h.iii.(b) Nondeductible Loss to Corporation When It Distributes Property to Shareholders for why valuation discounts are undesirable.

[1016] See part II.E.2.a Transferring the Business.

[1017] See part II.G.4.n

[1018] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

[1019] See part II.M.2 Buying into or Forming a Corporation, especially part II.M.2.c Contribution of Partnership Interest to Corporation

- This might be worked in with the general ideas of parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

- If the entity is already a C corporation or an S corporation, see part II.E.7 Migrating into Partnership Structure.

The C corporation would annually receive any earnings that are to be reinvested, whereas the balance would be owned by limited partners receiving distributions. The C corporation would loan back to the partnership the earnings to be reinvested:

- The corporation's interest income would be taxed at a federal rate of 21%, whereas the interest would be deducted at the higher individual rate, causing a taxpayer-favorable tax arbitrage. However, the Code § 199A deduction of up to 20% of qualified business income[1020] may reduce this benefit, and the interest might not be fully deductible.[1021]

- If the interest income becomes too significant, consider whether the personal holding company tax[1022] or accumulated earnings tax[1023] may be triggered. If these possible taxes eventually become a factor, consider part II.E.2.c Converting a C Corporation to an S Corporation.

Before doing any of this, consider that investing in a partnership might make a C corporation ineligible for part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. However, as described in part II.Q.7.k, not all businesses are eligible for the exclusion, and the exclusion applies only to stock originally issued to the owner (or to the person who gifted or bequeathed the stock to the current owner).

An S corporation with separate business lines could also reorganize into an S corporation parent with various subsidiaries, some of which might be disregarded entity LLCs and others of which might be C corporations that reinvest their profits and may qualify for part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. See part II.E.2.b Converting from S Corporation to C Corporation.

II.E.5. Recommended Long-Term Structure for Pass-Throughs – Description and Reasons

II.E.5.a. Strategic Income Tax Benefits of Recommended Structure

To maximize basis step-up of assets used in a business[1024] and promote tax-efficient exit strategies,[1025] the main entity should be a partnership. A partnership often is a better exit vehicle

[1020] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[1021] See part II.G.21.a Limitations on Deducting Business Interest Expense.
[1022] See part II.A.1.e Personal Holding Company Tax. I am not too concerned about this tax, because the corporation's distributive share of the partnership's gross income – not net income – would be compared against the interest income. In part II.A.1.e, see fn 69.
[1023] See part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax,
[1024] See parts II.H.2 Basis Step-Up Issues, II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, and II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[1025] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, for how to save capital gain tax on the seller-financed sale of an interest in a business. Also compare

than a C corporation, notwithstanding part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation;[1026] if the exclusion of gain on sale of a C corporation is particularly compelling, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[1027] However, corporate structure has some advantages:

- The partnership audit rules are becoming onerous and may artificially increase tax.[1028] Even though S corporations generally are pass-throughs, Congress has not targeted them, and the IRS needs to consider the burdens of making adjustments at both the entity and shareholder level.[1029]

- If the owners find a corporate buyer and can, on a tax-free basis, merge the business into the buyer and receive the buyer's stock, and they don't mind having low basis publicly-traded stock, then note that a tax-free merger or similar reorganization under Code § 368 is available only to corporations. Forming a corporation immediately before the sale might not work;[1030] I am unsure whether checking-the-box to elect corporate treatment helps any.

- If the owners would like for a qualified retirement plan to own the business, then an S corporation owned by an ESOP would be the ideal structure;[1031] on the other hand, an entity can start in the structure set forth below and then easily assign the interests in the operating LLCs to the S corporation general partner, in what generally would be a tax-free transaction.[1032]

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part II.Q.7.f Corporate Division into More Than One Corporation (including the cumbersome requirements of Code § 355 mentioned in parts II.Q.7.f.ii Code § 355 Requirements and II.Q.7.f.iii Active Business Requirement for Code § 355), with part II.Q.8 Exiting From or Dividing a Partnership (partnership divisions are generally tax-free, subject to certain rules about shifting unrealized gain in property whose value had been used to determine partnership percentage interests). Also, corporate redemptions might be recharacterized as distributions (see part II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When) and lose installment sale treatment, whereas partnership redemptions are nontaxable until basis is fully recovered (see part II.Q.7.b.ii Redemptions or Distributions Involving S Corporations Compared with Partnerships).

[1026] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(h) Partnership Use of Same Earnings as C Corporation – No Federal Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation in Sale of Goodwill (California)Partnership Use of Same Earnings as C Corporation – No Federal Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation in Sale of Goodwill (California).

[1027] See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (especially the text accompanying fns. 5057-5065).

[1028] See part II.G.20.c Audits of Partnership Returns.

[1029] See part II.G.20.b Audits of S Corporation Returns.

[1030] See part and II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations, especially fn. 3408.

[1031] See part II.G.22 Employee Stock Ownership Plans (ESOPs, which also explains that a partnership interest does not qualify as employer stock.

[1032] See parts II.M.2.c Contribution of Partnership Interest to Corporation and II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations.

Also, incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[1033]

Furthermore, a partnership often is a better vehicle for deducting start-up losses.[1034] However, using a partnership may knock one out of the small business exception to the limitations on deducting business interest.[1035]

II.E.5.b. Self-Employment Tax and State Income Tax Implications of Recommended Structure

To avoid self-employment tax, the entity should be a limited partnership, since an interest as a limited partner is not subject to self-employment (SE) tax.[1036] One should involve a local tax expert regarding any state or local taxes on pass-through entities in the states in which the entity does business.[1037]

II.E.5.c. Operating the Recommended Structure

II.E.5.c.i. General Considerations

This paradigm might not work well if owner compensation is needed to get the full Code § 199A deduction. See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure. This concern applies only if the ultimate taxpayer computing the deduction has taxable income in excess of certain thresholds. See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

To protect any real estate from business losses, maximize protection from creditors, and facilitate future restructuring of the business:

- Operations should be conducted in one or more LLCs, wholly owned by the limited partnership.

- Real estate should be held in one or more LLCs, wholly owned by the limited partnership. However, it would also be fine for the real estate to be held in a separate LLC outside of the limited partnership structure,[1038] if the owner materially participates in the business.[1039] Note

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[1033] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.

[1034] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.

[1035] See fn 1763 in part II.G.21.a Limitations on Deducting Business Interest Expense.

[1036] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

[1037] See part II.G.3 State Income Taxation.

[1038] The 2012 proposed regulations on the 3.8% tax on net investment income called into question the treatment of real estate rented to one's business. However, under the final regulations, any rental income considered nonpassive income under the self-charged rental rules would not be subject to the 3.8% tax. However, self-rental might not fully work, in that ownership of the real estate and the operating business might change over time. See parts II.I.8.c Application of 3.8% Tax to Rental Income. These issues can be addressed through special allocations and preferred returns inside the partnership structure.

[1039] The self-charged rental rules require that the landlord materially participate in the tenant's business (which the landlord must also own at least in part). See part II.I.8.c Application of 3.8% Tax to Rental Income and II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. If a business owner wants to rely on the more-than-100-hour significant participation rules rather than the material participation rules (which generally require more than 500 hours of work), then the business owner will not be able to rely on

that keeping the real estate inside the master LP umbrella would take the place of or facilitate grouping under the passive loss rules,[1040] which might be more important in the case of a real estate professional, because grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity, although those rules do provide a separate aggregation election.[1041]

- The real estate LLC(s) should lease the property to the operating LLC(s) for fair rental, which will be ignored for tax purposes but should allow the LLCs' respective assets to be segregated for purposes of protection from creditors.

The individuals involved in the business would own:

- An S corporation[1042] that is a 1% general partnership, and

- In the aggregate, the remaining 99% interest as limited partners.

To respect the S corporation's role as a general partner and to prevent the 3.8% tax from applying to their distributive shares of the S corporation's 1% interest as a general partner, the individuals would be employees of the S corporation and receive reasonable compensation for the services they perform. The employment arrangement also keeps the individual owners from tainting their limited partnership interests. The individuals' participation would be attributed to both the corporation (if applicable) and themselves.[1043]

On a daily basis, the operation is simple:

- The S corporation, as general partner of the limited partnership, controls each LLC subsidiary, because the limited partnership is the LLC's sole member.

- In this capacity, the S corporation appoints its owners as the LLC's managers (and can give them more traditional titles, such as president, chief financial officer, etc.) who sign documents on behalf of the LLC showing their capacity as the LLC's managers or other officers.

- Each LLC subsidiary pays the S corporation a management fee to the S corporation to pay for the cost of the services provided by the owners and any other employees leased to the LLC. To protect each LLC's separateness from the other LLCs (if the partnership has more than one LLC subsidiary), it would be best for each LLC to have its own employees and not simply use the S corporation as a central payroll master; however, this might not be practical,

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the self-rental exception and needs to keep the real estate inside the limited partnership umbrella so that the rent is disregarded for income tax purposes.

[1040] See part II.K.1.b.ii Grouping Activities – General Rules, particularly fn. 3017.

[1041] See fns. 3076-3077.

[1042] The entity being an LLC taxed as an S corporation would facilitate material participation of any trust that is or might eventually become an owner of the general partner. See part II.K.2.b Participation by an Estate or Nongrantor Trust. (Material participation is important to avoid the 3.8% tax on net investment income that might otherwise apply. See part II.I.8 Application of 3.8% Tax to Business Income.) If one is concerned that an LLC taxed as an S corporation might be subjected to self-employment tax because of some regulations that appear to be obsolete (see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election), using a statutory close corporation might be a safer approach. See text accompanying fn. 3200 within part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

[1043] See part II.K.1.c Limited Partnership with Corporate General Partner, particularly fn. 3052.

depending on how the business is run. An entity that is disregarded for income tax purposes is also disregarded for self-employment tax purposes, notwithstanding that it is treated as a separate entity for payroll tax purposes.[1044] ***Caution***: See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure. Also note that the reasonableness of the management fee (in terms of deducting the fee) depends on the reasonableness of the compensation of those whose services generated the management fee.[1045] Carefully document each employee-owner's employment agreement with the corporation.[1046]

- Only the S corporation and limited partnership file federal income tax returns. No matter how many LLC subsidiaries the partnership owns, the partnership files one federal income return to report all of their activity. (These materials do not attempt to cover state income or other tax issues in any systematic way that would help with state issues here.)

The tiered structure comes into play more when quarterly distributions are made to pay taxes or otherwise provide investment return to the owners. The LLCs would distribute part or all of their profits to the limited partnership, which then makes appropriate distributions to the limited partners and the S corporation general partner.

II.E.5.c.ii. Code § 199A Deduction under Recommended Structure

The S corporation general partner ("GP") of the limited partnership ("LP") receives a K-1 with QBI, wages, and UBIA. However, because the GP is a separate RPE from the LP, any activity on the K-1 the GP receives is siloed from the GP's own activities.[1047] In other words, K-1 income is QBI of the RPE that issues the K-1, not QBI of a business carried on by the K-1 recipient.

Thus, the GP needs to conduct its own trade or business for any wages it pays to count as being related to QBI.[1048] Guaranteed payments for services are not QBI.[1049]

When the GP receives a management fee and pays compensation to those working for the LP, those wages can be attributed back to the LP, but only if the W 2 wages were paid to the LP's common law employees or officers of the individual or RPE for employment by the LP – in other words, the GP leased the employees to the LP.[1050] Thus, compensation for services rendered by the limited partners themselves would not qualify, because they cannot be common law employees of the LP.

II.E.5.d. Net Investment Income Tax and Passive Loss Rules Under Recommended Structure

If any individual participates no more than 500 hours per year, that person might be subjected to the 3.8% tax more readily as a limited partner than as the owner of an S corporation, because limited partners have fewer ways to satisfy the material participation test than do other owners of

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[1044] See part II.B Limited Liability Company (LLC), fns. 340-341.
[1045] See fn 42 and the accompanying text in part II.A.1.b.i Compensating Individuals.
[1046] See fn 1846 in part II.G.25 Taxing Entity or Individual Performing Services.
[1047] See Reg. § 1.199A-6(b), reproduced shortly before fn 735 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[1048] See Reg. § 1.199A-2(b)(1), reproduced in part II.E.1.c.vi.(a) W-2 wages under Code § 199A.
[1049] Reg. § 1.199A-3(b)(2)(ii)(I), (J), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[1050] See Reg. § 1.199A-2(b)(2)(ii), reproduced in part II.E.1.c.vi.(a) W-2 wages under Code § 199A.

pass-through entities.[1051] On the other hand, if one is concerned only about avoiding the 3.8% tax on net investment income and not about disallowing passive losses or credits,[1052] then a limited partner who works for more than 100 hours generally would avoid the 3.8% tax.[1053]

II.E.5.e. Estate Planning Aspects of Recommended Structure

II.E.5.e.i. Family Conflicts

When some family members are in the business and others outside the business, conflicts can develop. The insiders want to reinvest earnings to grow the business and would like compensation commensurate with the value they view they bring to the business, including incentive equity compensation. The outsiders want to distribute earnings for their own use and believe that they should share in the business' growth because that is part of the ownership legacy their parents left to them.

The first generation might want to put a long-term lease on real estate used in the business and bequeath the real estate to the outsiders. That allows the outsiders to have significant cash flow locked in for a while and allows more (or all) of the business to be bequeathed to the insiders.

The cleanest break would be for any LLCs holding real estate to be distributed from the limited partnership and then bequeathed. Generally, such a distribution would not generate any income tax.[1054] To maximize income tax planning opportunities, all of the real estate LLCs might stay under one partnership umbrella.[1055]

If insiders are pitted against insiders, generally a partnership structure is easier to divide than a corporate structure.[1056]

II.E.5.e.ii. Estate Tax Deferral Using Recommended Structure

If long-term estate tax deferral is required,[1057] deferring estate on a partnership interest involves more uncertainty than deferring estate on stock.[1058]

II.E.5.e.iii. Grantor Trust Planning

When a business is sold, clients may wish to turn off grantor trust status[1059] so that the income tax burden does not deplete their assets more than they are comfortable with.

For a grantor trust owning an S corporation, generally grantor trust status should be turned off before January 1 of the year of the sale if the grantor wishes to avoid all tax on the gain on sale.

[1051] See part II.K.1.a.ii Material Participation.
[1052] See part II.K.1.i.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[1053] For more details, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[1054] See part II.Q.8 Exiting From or Dividing a Partnership.
[1055] See part II.Q.8.a Partnership as a Master Entity.
[1056] See parts II.Q.7 Exiting from or Dividing a Corporation (especially part II.Q.7.f Corporate Division into More Than One Corporation) and II.Q.8 Exiting From or Dividing a Partnership.
[1057] See part III.B.5.e.ii Code § 6166 Deferral.
[1058] See part III.B.5.e.ii.(b) Tiered Structures.
[1059] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

This concern is diminished or may not even exist for a partnership. See part III.B.2.j.i Changing Grantor Trust Status, especially the text accompanying fns. 6615-6617.

II.E.5.e.iv. Code § 2036

See part Code § 2036.

However, retaining voting stock and transferring nonvoting stock does not cause Code § 2036 inclusion.[1060] Using an S corporation general partner may help address this issue.

II.E.5.f. Recommended Structure with C Corporation

Because 2017 tax reform caused C corporation annual income taxation to be quite attractive, one might the S corporation shown in the structure to instead be a C corporation, and give the corporation more than 1%.

See part II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure.

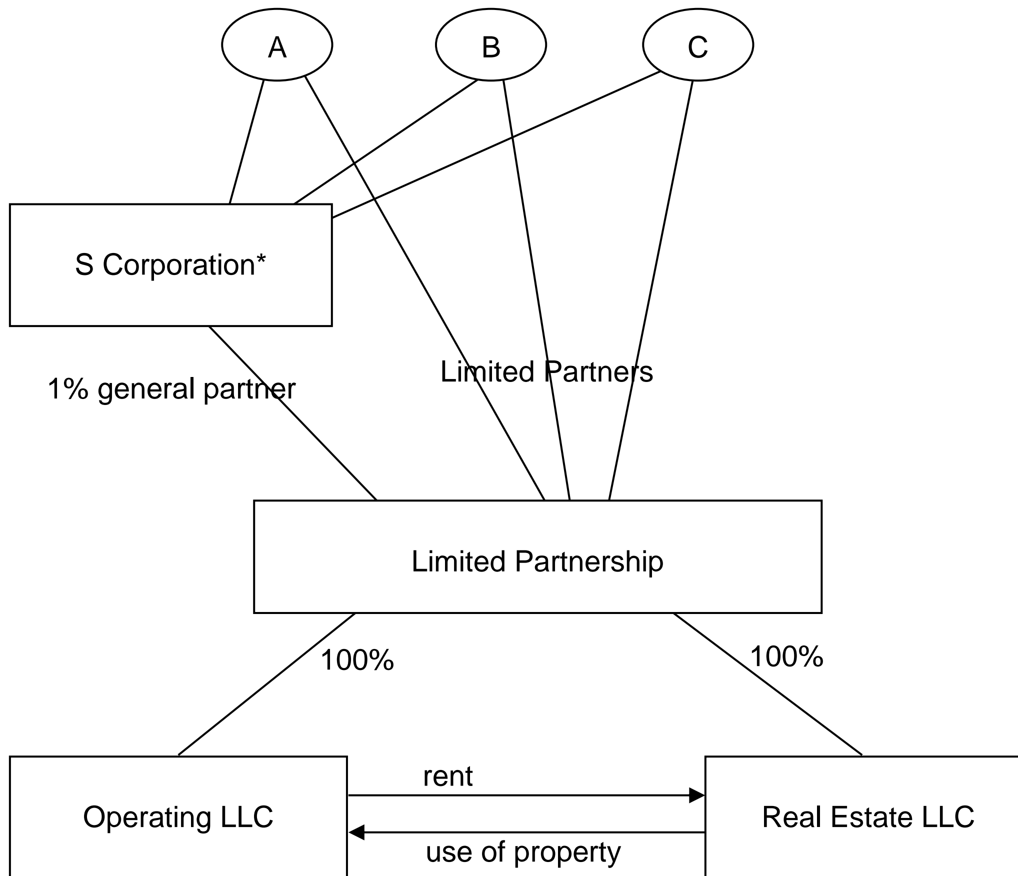
II.E.5.g. Other Aspects of Recommended Structure

Parts II.E.7 Migrating into Partnership Structure discusses moving to the recommended structure. Consider not only it but also part II.E.9 Real Estate Drop Down into Preferred Limited Partnership for real estate, long-lived tangible personal property, or intangible assets. The latter might generate royalty income subject to the 3.8% tax on net investment income, but in the recommended structure royalties would be disregarded the same way rent would be.

If the client would prefer not to have an S corporation general partner, see part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. Note, however, that a corporation transitioning into that structure (instead of retaining a preferred partnership interest) would pay tax; see parts II.P.3.a From Corporations to Partnerships and Sole Proprietorships and II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially parts II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property and II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[1060] See fn 237 in part II.A.2.i.i.(b). Why Nonvoting Shares Are Needed for Estate Planning.

II.E.6. Recommended Partnership Structure – Flowchart



* See part II.E.5.f. Recommended Structure with C Corporation.

If no real estate is ever held and the client balks at creating what the client perceives as too many entities, this structure could simply be a limited partnership without the LLCs. However, it would be much easier to start the operating business in its own LLC and later simply add other LLCs than it would be for the limited partnership to later transfer all of its business operations into a new LLC when real estate or a separate location or line of business is acquired.

II.J.8. Allocating Capital Gain to Distributable Net Income (DNI)

Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.[2628]

[2628] Reg. § 1.643(a)-3(e), Example (14).

II.J.8.a. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.[2629]

Code § 643(a)(3) provides:[2630]

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded from the income of a domestic trust,[2631] the gains must:

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

II.J.8.a.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.[2632]

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business" is not a capital asset.[2633] Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income.[2634] Whether other real estate is a capital asset depends on various facts.[2635]

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment[2636] to the extent it does not constitute certain depreciation

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[2629] Code § 643(a) provides:

> For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications….

[2630] Code § 643(a)(3) further provides:

> Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

[2631] Code § 643(a)(6)(C) provides:

> Paragraph (3) shall not apply to a foreign trust. In the case of such a trust, there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges.

[2632] Code § 643(a)(3); Reg. § 1.643(a)-3(a).

[2633] Code § 1221(2).

[2634] Section 401(c)(1) of the Uniform Principal & Income Act.

[2635] See part II.G.14 Future Development of Real Estate, especially fn. 1547.

[2636] Code § 1231(a)(3)(A)(i). See part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business.

recapture.[2637] Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset.[2638] Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

II.J.8.a.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.
- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal.[2639] In fact, one of the prongs discusses the treatment when capital gains are allocated to income.[2640]
- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

[2637] Depreciation recapture on the sale of tangible personal property is taxed as ordinary income; see fn. 1445. Depreciation recapture on the sale of real property tends to be taxed as a capital gain but at a higher rate; see fn. 1446. Note that cost segregation studies might break out building components as tangible personal property, so be sure to ask about this possibility when advising on the sale of a building. For various tips under regulations that applied starting in 2014, see Wood and Abdoo, "Applying the Final Tangible Property Regulations to Tenant Fit-Ups," *TM Real Estate Journal* (BNA) (9/2/2015); Atkinson and Afeman (KPMG), "The Tangible Property Regulations: Considerations For the Real Estate Industry," *TM Memorandum* (BNA) (9/7/2015). In October 2016, the IRS made major revisions to its Cost Segregation Audit Techniques Guide, found at https://www.irs.gov/businesses/cost-segregation-audit-techniques-guide-table-of-contents.

[2638] Letter Ruling 200243002. For more discussion of goodwill, see fns. 1917, 3951, and 3991 (especially the latter).

[2639] See part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal, which quotes the regulation.

[2640] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law and the various subparts thereunder.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.
- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?
- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading may be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

II.J.8.b. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

II.J.8.c. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses,[2641] are excluded from distributable net income (DNI).[2642]

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note that (b)(1) relates to determining whether capital gain has been allocated to income for state law purposes, and (b)(2) and (b)(3) relate to distributing capital gains that have been allocated to corpus.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.[2643]

[2641] Reg. § 1.643(a)-3(d) provides:

> *Capital losses*. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

See part II.J.3.i Planning for Excess Losses.

[2642] Reg. § 1.643(a)-1(a) provides:

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

Reg. § 1.643(a)-6 refers to DNI of a foreign trust (as defined in Code § 7701(a)(31)).

[2643] Former Reg. § 1.643(a)-3(a) provided:

> Except as provided in § 1.643(a)-6, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:

II.J.8.c.i. Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act,[2644] which will be referred to at UPIA for the rest of this part II.J.8.c.i, or its replacement, which is described in part II.J.5.b

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.[2645]

Generally, the Act allocates capital gains to principal.[2646] The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule.[2647] Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

II.J.8.c.i.(a). Power to Adjust

Capital gains may be reclassified as income if traditional trust accounting income principles cause insufficient receipts to be classified as income. See parts II.J.5.b.ii.(a) Power to Adjust.

II.J.8.c.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity.[2648] This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries'

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(1) Allocated to income under the terms of the governing instrument or local law by the generates fiduciary on its books or by notice to the beneficiary,
(2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or
(3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.

However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

See Zaritsky, Lane & Danforth, ¶3.03. Capital Gains and Losses, *Federal Income Taxation of Estates and Trusts* (WG&L).

[2644] See https://www.uniformlaws.org, with the 2008 amendments to the Uniform Principal & Income Act being referred to as the "Act" in the footnotes in this part II.J.8.c.i Capital Gain Allocated to Income Under State Law. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.

[2645] See part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

[2646] Act § 401.

[2647] For an analysis of how these ideas interact, see Sager, "Litigation and the Total Return Trust," *ACTEC Journal*, vol. 35, no. 3, p. 206 (Winter 2009).

[2648] See part III.A.4 Trust Accounting Income Regarding Business Interests.

claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.[2649]

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.
- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.
- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See parts II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust[2650] to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy.[2651] The bonus distributions might

[2649] See part II.J.8.c.i.(a) Power to Adjust.
[2650] Part II.J.8.c.i.(a) Power to Adjust.
[2651] "Conservative" does not necessarily equate with "stingy." Paying fixed (or inflation-adjusted) amounts that exceed net cash income can cause a trust's net asset value to decline, causing future income to decline, or might simply cause the principal not to grow sufficiently, causing the remaindermen's interests not to keep up with inflation. Using the power to adjust to make up for peaks and valleys would seem wiser than paying fixed (or inflation-adjusted) amounts. Generally, trustees should fairly and impartially balance

have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.d.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the .

II.J.8.c.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. See parts II.J.5.b.ii.(b) Unitrust and II.J.5.b.ii.(c) Comparing Power to Adjust to a Unitrust.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11).* The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.
>
> *Example (12).* The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.
>
> *Example (13).* The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow

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the beneficiaries' interests under the trust agreement and might consider additional communication to those currently receiving distributions about the peaks and valleys and provide to the beneficiaries (or encourage them to obtain) advice about how to manage these peaks and valleys.

a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.[2652]

II.J.8.c.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:[2653]

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

[2652] Letter Ruling 201117005 approved a unitrust expressly authorized by state law:

> State Statute provides that the grantor of a trust may create an express total return unitrust which will become effective as provided in the trust document without requiring a conversion of an income trust to a total return unitrust under the provisions of State Statute. An express total return unitrust created by the grantor of the trust shall be treated as a unitrust under State Statute only if the terms of the trust document contain all of the following provisions: (a) that distributions from the trust will be unitrust amounts and the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined; (b) the percentage to be used to calculate the unitrust amount, provided the percentage used is not greater than 5 percent nor less than 3 percent; (c) the method to be used in determining the fair market value of the trust; and (d) which assets, if any, are to be excluded in determining the unitrust amount.

[2653] Act § 103(a).

II.J.8.c.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law.[2654] The Uniform Principal and Income Act ("UPIA") and the Uniform Fiduciary Principal & Income Act ("UFIPA") authorizes the trust agreement to override the Act.[2655]

However, Reg. § 1.643(b)-1[2656] does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

The regulation respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.

[2654] Code § 643(b) provides:

> For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

[2655] Section 103(a) of UPIA provides:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

For UFIPA's counterpart, UFIPA § 201(a), see text preceding the text accompanying fn 2557 in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

[2656] This version of the regulation applies to taxable years of trusts and estates ending after January 2, 2004.

> Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.[2657]

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

For the "reasonable and impartial exercise" requirement in the context of the power to adjust, see part II.J.5.b.ii.(a) Power to Adjust.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries.[2658] That language comes from

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[2657] The regulation sets forth parameters for switching methods:

> A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances.

[2658] As with everything else, the reader must exercise independent legal judgment (or, if the reader is not an estate planning lawyer, retain one) before using the language reproduced below:

> The trustee is authorized to apportion any receipt or disbursement between principal and income, notwithstanding the apportionment that would apply under [applicable state law] apart from this provision; to determine the depletable, depreciable or amortizable interest of the principal and income in any property included among the trust estate subject to being depleted, depreciated or amortized, and to apportion the amount received from such property between principal and income; to maintain reasonable reserves for depletion, depreciation, amortization and obsolescence; to allocate to income or principal of the trust estate any gains or losses realized upon the sale or disposition of any part of the trust estate; to determine what part, if any, of the actual income received upon a wasting investment or upon any security purchased or acquired at a premium shall be returned and added to principal to prevent a diminution of principal upon exhaustion or maturity thereof; and to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no

the marital deduction regulations.[2659] Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status,[2660] does not constitute a power of

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> income or slight income; provided, however, that the trustee, in taking any action under this Section, must reasonably and fairly balance the interests of the income and remainder beneficiaries.

For an example of how the clause, "to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income," can come in handy, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, especially fn. 2825.

[2659] Reg. § 20.2056(b)-5(f)(1), which governs general power of appointment marital deduction trusts under Code § 2056(b)(5), looks to whether:

> the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1 of this chapter.

Reg. § 20.2056(b)-5(f)(4) elaborates:

> Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus….

For QTIP (qualified terminable interest property) trusts, Reg. § 20.2056(b)-7(d)(1) provides:

> A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

Reg. § 20.2056(b)-7(d)(2) also circles back to the general power of appointment marital deduction rules:

> *Entitled for life to all income*. The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

[2660] Code § 674(b)(8); Reg. § 1.674(a)-1(b)(1)(iv).

appointment,[2661] and does not have generation-skipping transfer tax implications.[2662] The trustee might want to consider providing accountings or other notices to the beneficiaries that would start

[2661] Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

Although a trustee's allocations to income and principal ordinarily will not cause gift tax issues, other decisions that affect distributions might cause gift tax issues if the trustee is also a beneficiary. Reg. § 25.2511-1(g)(2) provides a safe harbor, which is reproduced in the text accompanying fn 2398 in part II.J.2.b Trust Provisions Authorizing Distributions. See also Reg. § 20.2041-1(c)(2) (exception to estate tax general power of appointment – see text accompanying fn 2056 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap).

See fn. 2446 for additional authority on ascertainable standards.

Letter Ruling 8908032 recognized that Reg. §§ 20.2041-1(b)(1) generally prevents administrative powers from creating a general power of appointment:

> …. Although the amount of income that A may receive each year is generally limited, the trust provides that any income from real estate must be distributed first and that all the income from real estate be distributed to A even if such distribution exceeds the annual limitation. Thus, if the trust had substantial income from real estate, it is possible for A to receive distributions in excess of the annual limitation imposed by the trust.
>
> Where the holder of a power is not completely free from legal control or restraint in the disposition of property, a power held by the holder would not be a general power of appointment. Such legal control or restraint exists when the holder is legally accountable for its exercise. fiduciary duties imposed by local law are always subject to the control of the courts and the holder is always under a legal duty to account. See *Security-Peoples Trust Company v. United States*, 238 F.Supp. 40 (W.D. Pa. 1965). The initial step in determining whether a decedent has a general power of appointment is to determine, in light of local law, the interest conveyed to the decedent under trust; *i.e.*, the extent to which consonant with testamentary trust provisions, the decedent could invade and consume the principal. See *Morgan v. Commissioner*, 309 U.S. 78 (1940).
>
> It is necessary to look to the law of State X to determine whether A has the power to alter the beneficial interest under the trust. If A appointed herself trustee, A, as the trustee, would have the authority under the trust to sell trust assets and to invest the proceeds in real estate. Thus, A could cause trust income from real estate to exceed the limitation set forth in the trust for income distributions from other sources and, consequently, increase the total income distributions to A. Such investment policy and actions by A as the trustee would result in a shift of the beneficial interest of the trust. However, A would not have complete freedom to set investment policy for the trust. The statutory law of State X requires that a trustee consider the relative interests of both income and remainder beneficiaries in determining the prudence of any investment and imposes a duty on the trustee to administer the trust with due regard to the respective interests of income beneficiaries and remainderpersons in accordance with the terms of the trust. In addition, the highest court in State X has addressed the responsibilities of the trustee and stated that:
>
> > It is the duty of the trustees to preserve the corpus of the trust for the remaindermen and to secure the usual rate of income upon safe investments for the life tenant, and to use a sound discretion in reference to each of those objectives. They cannot postpone the yielding of income for the increase of capital, nor select a wasting or hazardous investment for the sake of greater present income.
>
> *Congdon v. Congdon*, 160 Minn. 343, 200 N.W. 76 (1924).
>
> Moreover, *In re Clarke's Will*, 204 Minn. 574, 284 N.W. 876 (1939), addressed a situation where the trustee, who was also the income beneficiary, treated trust property incorrectly as "income" rather than "capital" and made erroneous distributions to herself. The court held that the trustee-income beneficiary had a duty to distinguish between the rights of the life tenant and those of the remaindermen with meticulous care. The court found that, although there had been no intentional

running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.[2663]

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.[2664]

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

II.J.8.c.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the

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wrong, there was an invasion of the rights of the remaindermen by the trustee-income beneficiary that amounted to fraud, irrespective of intention.

The law of State X clearly imposes a strong fiduciary duty on a trustee to protect the interests of all beneficiaries of the trust. While A, as the trustee, may invest trust assets in real estate that may produce sufficient income resulting in an increase in distributions to A, A cannot adopt an investment policy that would be detrimental to the interests of the remaindermen. Neither Trust 1 nor Trust 2 gives A, as the income beneficiary, any control over investment policy or income withdrawal. Due to the restrictions imposed by both the law of State X and the trust instruments, A does not have an unfettered right to change the interests of the beneficiaries.

Accordingly, A's power to remove the current trustee and appoint anyone, including A, as the trustee is not a general power of appointment as described in section 2041 of the Code.

[2662] Reg. § 26.2601-1(b)(4)(i)(D)(2) provides:

… administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

[2663] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.

[2664] See fn. 2700.

reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

II.J.8.c.ii. Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1).* Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.
>
> *Example (2).* The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.
>
> *Example (3).* The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. The beneficiary needs regular annual distributions that cannot be made using a power to adjust. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to

be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. The beneficiary's need for distributions in excess of income is sporadic. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections,[2665] so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

II.J.8.c.iii. Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.
>
> *Example (6).* Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required

[2665] Paragraph (16) of that section authorizes the trustee to "exercise elections with respect to federal, state, and local taxes." The official Comment provides:

> Paragraph (16) authorizes a trustee to make elections with respect to taxes. The Uniform Trust Code leaves to other law the issue of whether the trustee, in making such elections, must make compensating adjustments in the beneficiaries' interests.

to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year.[2666] For example, any distribution made on or before March 5, 2020 can be treated as a 2019 or 2020 distribution.[2667] This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7.[2668] By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.[2669]

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus.[2670] The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(2), Reg. § 1.643(a)-3(b)(3) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal

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[2666] Code § 663(b).

[2667] In a leap year, the deadline is March 5; in other years, the deadline in March 6.

[2668] Reg. § 1.663(b)-1(a)(2)(i).

[2669] Reg. § 1.663(b)-1(a)(2)(ii). The election may be made on an extended return but not on an amended return filed after the (extended) due date. Reg. § 1.663(b)-2(a)(1). If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office (under Code § 6091 and the regulations thereunder) with which a return by such trust would be filed if such trust were required to file a return for such taxable year. Reg. § 1.663(b)-2(a)(2).

[2670] The authority to distribute principal for welfare would be helpful, but the trustee should not be a related or subordinate party. See Code § 2041(b)(1), absent the application of Code § 2041(b)(1)(A) and the other exceptions, combined with Rev. Rul. 95-58 and a variety of private letter rulings applying that Rev. Rul. to Code § 2041, found in fn. 6492. Alternatively, suppose the trustee has the authority to distribute under ascertainable standards, but the trustee has the discretion to consider or ignore the beneficiary's other resources. The trustee might have considered the other resources and taken a minimalist approach to distributions throughout the year; but, when doing 65-day-rule planning, the trustee might chooses to ignore other resources and take an expansive view of the authority to make distributions.

constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.[2671]

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

II.J.8.c.iv. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

- Electing not to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) unless it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to

[2671] Code § 643(e)(2).

five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

II.J.8.c.v. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.v. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

II.J.8.d. Distribution in Kind; Specific Bequests

II.J.8.d.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI[2672] or constitutes a bequest of income,[2673] a distribution is a nontaxable gift[2674] (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).[2675]

[2672] Reg. § 1.102-1(d).
[2673] Reg. §§ 1.102-1(b), (c) and 1.663(a)-1(b)(2)(i).
[2674] Reg. § 1.102-1(a), (d).
[2675] See part III.B.1.c.i Gifts with Consideration – Bargain Sales.

When a trust distributes property to satisfy a pecuniary distribution[2676] (even if the amount is expressly authorized to be satisfied in cash or in kind),[2677] the trust recognizes gain on the deemed sale,[2678] even if the trust's residue is less than the pecuniary obligation.[2679] Such a pecuniary

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[2676] Similar logic applies to satisfying a debt. Citing Rev. Rul. 66-207 (fn 2679), Rev. Rul. 74-178 held:

> In the instant case the fair market value of the shares of stock at the time such stock was transferred to the creditor is equal to the amount of the claim satisfied ($8,000). However, since the executor did not elect the alternate valuation date, the estate's basis in the shares transferred is the fair market value of the shares at the date of the decedent's death ($7,000). Accordingly, it is held that upon such transfer the estate realized a gain of $1,000, which is the excess of the amount of the claim satisfied by the transfer over the estate's basis in the shares. Had the estate's basis in the shares of stock transferred exceeded the amount of the claim satisfied, the estate would have sustained a loss deductible to the extent allowed in sections 1211 and 1212 of the Code.

[2677] Rev. Rul. 86-105 held:

> 1. A bequest of "assets, in cash or in kind or partly in each," with a fair market value at date of distribution equal to a specified amount is a bequest of a "specific sum of money" under section 663(a) of the Code.
> 2. The bequest of unspecified property with a specified value at the date of distribution creates a right to receive a "specific dollar amount" under section 1.661(a)-2(f)(1) of the regulations. Therefore, gain or loss is realized by the estate upon a distribution in kind.

[2678] Reg. § 1.661(a)-2(f) provides:

> Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e).

Reg. § 1.651(a)-2(d) provides:

> If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income. This paragraph (d) applies for taxable years of trusts ending after January 2, 2004.

[2679] Rev. Rul. 66-207 included the following facts and conclusion:

> By the terms of the decedent's will he made a bequest of a specific sum of money in the amount of 250x dollars to be used to create a trust for the benefit of a designated beneficiary. After payment of all debts, costs of administration, claims, and specific bequests, other than the sum of 250x dollars, the executor finds that all he has left in the estate are assets now having a fair market value of 200x dollars and an aggregate basis to the estate of 150x dollars. Included among these assets is cash in the amount of 10x dollars. All of these assets will be transferred in trust to the designated trustee in accordance with the terms of the will….
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> Section 1.661(a)-2(f) of the regulations provides, in part, that no gain or loss is realized by the trust or estate by reason of the distribution of property in kind unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount. Under this provision of the regulations whenever property other than money is distributed by an estate to any beneficiary, including a trust, in satisfaction of a cash bequest the estate realizes gain or loss measured by the difference between the amount of the bequest satisfied and the basis to the estate of the property so distributed. See *William R. Kenan, Jr., et al. v. Commissioner*, 114 F.2d 217 (1940); and *Sarah P. Suisman v. Eaton*, 15 F.Supp. 113 (1935), *affirmed per curiam*, 83 F.2d 1019, *certiorari denied*, 299 U.S 573.
>
> When the executor of this estate distributes the property remaining in the estate to the designated trustee in creation of the trust the estate will realize a gain of 50x dollars. This is the difference

obligation includes an equalizing distribution[2680] (presumably unless expressed as a fractional share). This rule includes a pecuniary obligation in the form of an annuity payment to a beneficiary,[2681] and the gain recognized in paying the annuity is not included in the beneficiary's

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between the amount of the bequest satisfied by distribution of property other than cash (200x dollars less 10x dollars cash, or 190x dollars) and the basis (150x dollars less 10x dollars cash or 140x dollars) to the estate of the assets other than cash distributed in satisfaction of the bequest of a specific sum of money. The effect of the distribution will be the same as if the executor sold the remaining assets of the estate and distributed the proceeds to the trustee in trust.

No amount is deductible by the estate under section 661 of the Code or includible in gross income of the trust under section 662 of the Code since the distribution will be in satisfaction of a bequest of a specific sum of money, as defined by section 1.663(a)-1(b) of the regulations.

Accordingly, a final distribution by the executor of an estate of appreciated property, in order to satisfy a pecuniary legacy, will result in a gain to the estate, although such distribution is of an insufficient amount to completely satisfy such bequest.

[2680] Rev. Rul. 82-4 held:

In this case, as in Rev. Rul. 66-207, the residue equal to the value of 100,000 shares of X company stock as of date of death bequeathed to C is a "bequest of a specific sum of money," as that term is defined in section 1.663(a)-1(b)(1) of the regulations, because the amount is ascertainable under the terms of A's will as of the date of A's death. Thus, no amount is deductible by the estate under section 661 of the Code or includible in the gross income of B under section 662. Also, under section 1.661(a)-2(f)(1), the estate realizes a gain on the distribution in kind of appreciated property in satisfaction of C's right to receive a distribution in a specific dollar amount.

Holding

The estate realizes gain of $60,000 (date of distribution value ($180,000) less the basis of the property in the estate ($120,000)) for federal income tax purposes when the executor distributes the entire residuary estate to C to equalize to the extent possible the respective shares of total transfers received from the decedent.

If in this case the value of the residuary estate had been, for example, $250,000, the property remaining after satisfaction of the $200,000 bequest to C ($50,000) would pass to B and C in equal shares. The estate would realize no gain or loss under section 1.661(a)-2(f)(1) of the regulations upon distribution of this portion of the $50,000 residue because the distribution would not be in satisfaction of the right to receive a distribution in a specific dollar amount.

[2681] Rev. Rul. 83-75, citing *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940), reasoned:

The trustee was obligated to pay a fixed annuity to qualified charitable organizations. Under the principles of section 1.661(a)-2(f)(1) of the regulations and the case law cited, the distribution of appreciated securities causes the trust to realize gain or loss if the distribution satisfies a right to receive a distribution in a specific dollar amount. Although the trustee has authority to pay the annuity to qualified charities of the trustee's choice, the distribution satisfies a right to receive a specified dollar amount. It is not necessary or practical to identify a particular qualified charity with the right to receive a specified dollar amount. In *Kenan*, the court stated that the word "exchange" does not necessarily have the connotation of a bilateral agreement which may be said to attach to the word "sale". Thus, the distribution in this case is an exchange even though the trustee consulted with no one before satisfying the obligation to pay the annuity by using the appreciated securities.

Rev. Rul. 83-75 held:

The distribution by the trust of corpus consisting of appreciated securities in satisfaction of its obligation to pay a fixed annuity to a qualified charitable organization is a sale or exchange of the securities that results in taxable gain to the trust.

Rev. Proc. 2007-45, § 8.02(2) says:

Payment requirements. CLATs are not subject to any minimum or maximum payout requirements. The governing instrument of a CLAT must provide for the payment to a charitable organization of a fixed dollar amount or a fixed percentage of the initial net fair market value of the assets transferred to the trust. Alternatively, the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases

distributive net income (DNI) unless the rules for including capital gain in DNI are satisfied.[2682] If the trust's residue is less than the pecuniary obligation, the fact that all bequests are protected by Code § 663(a)(1) and therefore no residual beneficiary can pick up income under Code § 662 means that the trust will pay the tax, given that the beneficiaries of the protected bequests will not be picking up that income;[2683] note that the trustee will need to reserve for this tax before making distributions to beneficiaries and may have a mismatch for net investment income tax purposes as well.[2684] However, when a charity that was the annuity recipient was bequeathed the remainder, the resulting merger of interests and trust termination were not a taxable event.[2685] Also, if the bequest is satisfied using date-of-death values, presumably no gain or loss would be realized, but to qualify for the marital[2686] or charitable[2687] deduction the assets' value relative to date of death values must be "fairly representative of appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer."

If a trust makes a non-pro rata distribution of residue without either the trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received a pro rata distribution and exchanged it with the other beneficiaries.[2688] Otherwise, generally the trust does not recognize any gain or loss and the beneficiaries receive the same basis as the trust's;[2689] for further analysis of dividing trusts (including on termination), see part II.D.5 Severing Trusts with Multiple Grantors. However, the trust may elect to treat all property distributions during the taxable year as sales,[2690] but losses in transactions with beneficiaries and other related parties are disallowed except to the extent that they are from an estate (including a revocable trust electing to be taxed as an estate)[2691] satisfying a pecuniary bequest.[2692] The loss disallowance

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> during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded. The annuity payments may be made in cash or in kind. If the trustee distributes appreciated property in satisfaction of the required annuity payment, the donor will realize capital gain on the assets distributed to satisfy part or all of the annuity payment.

[2682] Rev. Rul. 68-392, which went through the rules that existed at that time regarding including capital gain in DNI and concluded that they did not apply. However, since then, the regulations have changed, so a different result may occur; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

[2683] Letter Ruling 9548020, citing Rev. Rul. 66-207, a relevant excerpt from which is reproduced in fn 2679.

[2684] Deductions for regular income tax purposes limit the deduction for distributions to beneficiaries. If those same deductions do not apply for net investment income (NII) tax purposes, the trust's NII may be subjected to NII tax. See part II.I.6 Deductions Against NII within part II.I 3.8% Tax on Excess Net Investment Income (NII).

[2685] Letter Ruling 201928005, holding that Rev. Rul. 83-75 (fn 2681) did not apply.

[2686] Rev. Proc. 64-19.

[2687] Letter Ruling 8339005.

[2688] Rev. Rul. 69-486. See Zaritsky, Lane & Danforth, ¶2.19. Gain on the Division, Termination, or Reformation of a Trust, *Federal Income Taxation of Estates and Trusts* (WG&L).

[2689] Rev. Rul. 69-486. Reg. § 1.1015-2(a) provides:

> (1) In the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.
>
> (2) The principles stated in paragraph (b) of § 1.1015-1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust after December 31, 1920.

[2690] Code § 643(e)(3).

[2691] See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

[2692] Code § 267, especially subsections (a)(1), (b)(6) and (b)(13).

applies even if the distribution, taken as a whole, results in a net gain. Thus, gains are recognized and losses generally are not.

The amount deemed distributed is the lesser of the property's basis or fair market value,[2693] unless gain was recognized, in which case it is the property's value.[2694]

Distributing low basis assets will generate a new basis (often a step-up) when the beneficiary dies. However, distributed assets are subject to the beneficiary's creditors, changes in the beneficiary's estate tax posture (including not only changes in the tax law but also changes in financial situation through the beneficiary's own efforts or through marriage and change in residence to a state that imposes its own estate tax), and changes in the beneficiary's dispositive goals. To get a basis step-up, I would rather add (perhaps by decanting)[2695] a formula general power of appointment, as described in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.[2696]

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

II.J.8.d.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.[2697]

II.J.8.e. Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited

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[2693] Code § 643(e)(2).
[2694] Code § 643(e)(3).
[2695] See part II.J.18.c Decanting.
[2696] Especially the text accompanying fns 2058-2060 for the formula. Part II.H.2.k also mentions that giving a nonadverse the trustee the right to veto any exercise in favor of the beneficiary's creditors generates estate inclusion even though a corporate trustee is likely to exercise that veto due to its fiduciary liability. In most states, creditors cannot reach an unexercised general power of appointment.
[2697] Reg. § 1.663(a)-1(a), which provides further:

> Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

amount of time.[2698] (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)[2699]

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act, consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.[2700]

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income.[2701] Only the following distributions from an entity are not considered trust accounting income:[2702]

- property other than money;

[2698] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

[2699] Rev. Proc. 2015-3, Section 4.01(36) identifies as an area in which rulings or determination letters will not ordinarily be issued:

> Whether a trust that will calculate the unitrust amount under § 664(d)(3) qualifies as a § 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under § 643(b) and income for Federal income tax purposes for the benefit of the unitrust recipient.

Check the most recent year's Rev. Proc. 20xx-3 [where "xx" represents the last two digits of the year] to see whether this remains on the list. For further discussion, see Fox, ¶ 25.20[5] NIMCRUTs—Where Timing of Trust Income Is Controlled by Grantor, Trustee, or Related or Subordinate Person, *Charitable Giving: Taxation, Planning, and Strategies* (WG&L).

When administering any partnership, be careful to avoid any direct or indirect violation of the prohibition against counting precontribution gain as income found in Reg. § 1.664-3(a)(1)(i)(b)(3):

> For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

[2700] In *Crisp v. U.S.*, 76 A.F.T.R.2d 95-6261, 34 Fed. Cl. 112 (1995), the Court of Claims held that capital gain distributed in the ordinary course of a partnership's operations was allocated to income (because the settlor intended to distribute it) and therefore was includible in DNI.

[2701] Act § 401(b).

[2702] Act § 401(c).

- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;

- money received in total or partial liquidation of the entity; and

- money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership.[2703] If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division.[2704] Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.[2705]

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI.[2706] Furthermore, interrelated calculations might be required for a mandatory income trust.[2707] Generally, we should look to see whether planning under part II.J.8.c.i Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

[2703] See part II.M.3.b Exception: Diversification of Investment Risk.
[2704] See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[2705] Although Illinois subjects partnerships to an income tax called the "replacement tax," it does not tax investment partnerships. See fn. 5130.
[2706] See part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary.
[2707] Part III.A.4 Trust Accounting Income Regarding Business Interests describes trust accounting income, income tax, and some tough fiduciary issues that arise when a mandatory income trust owns an business interest. See also part III.F.2 Trust Accounting and Taxation.

II.J.8.f. Consequences of Allocating Capital Gain to DNI

II.J.8.f.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

II.J.8.f.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class.[2708] To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.[2709]

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income.[2710] Such indirect expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes.[2711] Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income.[2712] For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations

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[2708] Reg. § 1.652(b)-3(a).
[2709] Reg. § 1.652(b)-3(d).
[2710] Reg. § 1.652(b)-3(b) provides:

> The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to non-taxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instances, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

An expense allocated to tax-exempt income and therefore disallowed for income tax purposes may be deductible for estate tax purposes. Rev. Rul. 59-32, which Rev. Rul. 63-27 clarifies as showing just one among the acceptable methods of such a calculation.
[2711] Reg. § 1.652(b)-3(c).
[2712] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 2221-2222).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.[2713]

[2713] Reg. § 1.642(c)-3(b)(2) provides:

Determination of the character of an amount deductible under section 642(c). In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust, whether or not included in gross income, a provision in the governing instrument or in local law that specifically provides the source out of which amounts are to be paid, permanently set aside, or used for such a purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See § 1.643(a)-5(b) for the method of determining the allocable portion of exempt income and foreign income. This paragraph (b)(2) is illustrated by the following examples:

Example (1). A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of $10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the $10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of income tax consequences, because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.

Example (2). A trust instrument provides that 100 percent of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to B, a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year. Accordingly, for purposes of section 642(c), the full amount distributed to charity is deemed to consist of ordinary income.

Reg. § 1.643(a)-5(b) provides:

If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)-6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument or local law specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provision controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or local law, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see Examples 1 and 2 of § 1.662(b)-2 and § 1.662(c)-4(e).

- Special rules apply to depreciation deductions.[2714]

II.J.8.f.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:[2715]

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law,[2716] subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.[2717]

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions),[2718] it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.[2719]

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status

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[2714] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[2715] Code § 661(b).

[2716] Reg. § 1.661(b)-1.

[2717] Code § 661(c). Reg. § 1.661(c)-1, which was adopted 12/19/56 and amended 12/15/64, provides:

> An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

[2718] See fn. 2713.

[2719] In adopting Reg. § 1.642(c)-3(b)(2), which is quoted in fn. 2713, T.D. 9582 rebuffed criticism of the regulation, saying:

> Permitting an ordering rule with no economic effect independent of income tax consequences to supersede the pro rata allocation rule generally applicable under Subchapter J would, in effect, permit taxpayers to deviate at will from the general rule imposed throughout Subchapter J in the case of all kinds of complex trusts.

in the beneficiary's hands[2720] (which, among other things, is important for net investment income tax purposes).[2721]

[2720] Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

[2721] See fn. 2241, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."[2722]

When allocating among beneficiaries:[2723]

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

II.J.8.f.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of

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[2722] Reg. § 1.662(b)-1, which is quoted in fully in fn. 2720. Furthermore, Reg. § 1.652(b)-2(a) provides:

> The amounts specified in § 1.652(a)-1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000 and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

[2723] Reg. § 1.652(b)-2(a). Reg. § 1.652(b)-2(b) provides the following:

> (1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.
> (2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.
> (3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary or part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

II.J.8.g. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

II.J.19. Trusts Holding Annuities

Code § 72(a) defers income tax on an annuity until the owner receives a distribution.

First, we discuss part II.J.19.a Code § 72(u)(1) Requirement of Natural Person (N/A to Most Trusts).

Then the general taxation of distributions from annuity contracts is in part II.J.19.b Taxation of Distributions under an Annuity Contract.

Also consider parts II.J.19.c Code § 72(q) 10% Penalty for Early Distributions from Annuity Contracts and II.J.19.d Code § 72(s) Required Distributions Where Holder Dies Before Entire Interest Is Distributed.

Letter Ruling 202031008 provided guidance when an annuity contract is issued to a trust. It is discussed below in parts II.J.19.e Annuity Contract Issued to Grantor Trust and II.J.19.f Annuity Contract Issued to Nongrantor Trust.

Code § 1035 controls swapping annuity contracts tax-free and is discussed in part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.

II.J.19.a. Code § 72(u)(1) Requirement of Natural Person (N/A to Most Trusts)

Code § 72(u)(1) imposes ordinary income tax annually notwithstanding this rule if the annuity contract is held by "a person who is not a natural person." However, numerous private letter

rulings allow nongrantor trusts to hold annuity contracts. For example, Letter Ruling 202118002 explains Code § 72(u) generally:

> Section 72(u) was enacted as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 1986-3 (Vol. 1) C.B. 1. The legislative history contains the following reasons for enacting section 72(u):
>
> > The committee believes that the present-law rules relating to deferred annuity contracts present an opportunity for employers to fund, on a tax- favored basis, significant amounts of deferred compensation for employees. This favorable tax treatment may create a disincentive for employers to provide benefits to employees under qualified pension plans, which are subject to significantly greater restrictions. In addition, because deferred annuity contracts can be provided to a limited class of employees, rather than to employees generally (as is required in the case of a qualified pension plan), the committee is concerned that the present-law treatment of deferred annuity contracts dilutes the effect of the nondiscrimination rules applicable to qualified pension plans.
>
> H.R. Rep. No. 426, 99th Cong., 1st Sess. 703 (1985), 1986-3 (Vol. 2) C.B. 1, 580.
>
> The flush language of section 72(u)(1), however, provides that holding by a trust or other entity as an agent for a natural person is not taken into account. The legislative history contains the following explanation of this flush language:
>
> > In the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person. Thus, if a group annuity contract is held by a corporation as an agent for natural persons who are the beneficial owners of the contracts, the contract is treated as an annuity contract for Federal income tax purposes. However, the committee intends that, if an employer is the nominal owner of an annuity contract, the beneficial owners of which are employees, the contract will be treated as held by the employer. The committee intends this rule because it is concerned that the Internal Revenue Service would have difficulty monitoring compliance with the general rule that a deferred annuity is not available on a tax-favored basis, to fund nonqualified deferred compensation.
>
> H.R. Rep. No. 426, 99th Cong., 1st Sess. 704 (1985), 1986-3 (Vol. 2) C.B. 1, 580.

After explaining that the trust was not an agent for its beneficiary, when holding that Code § 72(u)(1) did not apply, Letter Ruling 202118002 reasoned:

> A trustee generally has fiduciary obligations under trust documents and governing law that are inconsistent with it acting as an agent for the beneficiary of a trust. *See*, *e.g.*, *Restatement (Third) of Agency* section 1.01 cmt. g (2018); *Restatement (Third) of Trusts* section 5(e) & cmt. e (2003); *Restatement (Second) of Agency* section 14B (1958). This principle also applies for federal income tax purposes. *See*, *e.g.*, Rev. Rul. 69-300; *United States v. Anderson*, 132 F.2d 98 (6th Cir. 1942). Accordingly, the phrase "as an agent" in the flush language of section 72(u)(1) pertains only to "other entity." It does not pertain to "trust." Thus, for purposes of section 72(u)(1), the holding of an annuity contract by a trust is not taken into account if the contract is held for a natural person.

The Trust would be the "holder" of its annuity contract within the meaning of section 72(u)(1) because the Trust would be designated in its annuity contract as the owner of the contract. The Trust is a not a grantor trust, and A is the sole beneficiary of the Trust. Thus, the Trust would be holding its annuity contract for the benefit of A. A is a natural person. Accordingly, the holding of the annuity contract by the Trust would not be taken into account for purposes of section 72(u)(1).

This determination is consistent with the purpose for adopting section 72(u). Section 72(u) was adopted to encourage employers to offer benefits to employees under qualified pension plans, which are subject to certain restrictions and generally must be made available to a wide class of employees, as opposed to offering deferred compensation to a limited class of employees that is funded by deferred annuity contacts. Because the annuity contract would not be issued in an employment context, the arrangement would not provide the sort of tax-favored benefit that section 72(u) was intended to limit.

II.J.19.b. Taxation of Distributions under an Annuity Contract

Once an annuity is annuitized, Code § 72(b), "Exclusion ratio," determines how much of a payment is recovery of "investment in the contract" (which can be, but is not necessarily, the same as basis) that is nontaxable and how much is ordinary income:

(1) *In general*. Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

(2) *Exclusion limited to investment*. The portion of any amount received as an annuity which is excluded from gross income under paragraph (1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

(3) *Deduction where annuity payments cease before entire investment recovered*.

(A) *In general*. If -

(i) after the annuity starting date, payments as an annuity under the contract cease by reason of the death of an annuitant, and

(ii) as of the date of such cessation, there is unrecovered investment in the contract,

the amount of such unrecovered investment (in excess of any amount specified in subsection (e)(5) which was not included in gross income) shall be allowed as a deduction to the annuitant for his last taxable year.

(B) Payments to other persons. In the case of any contract which provides for payments meeting the requirements of subparagraphs (B) and (C) of subsection (c)(2) , the deduction under subparagraph (A) shall be allowed to the person entitled to such payments for the taxable year in which such payments are received.

(C) *Net operating loss deductions provided*. For purposes of section 172 , a deduction allowed under this paragraph shall be treated as if it were attributable to a trade or business of the taxpayer.

(4) *Unrecovered investment*. For purposes of this subsection, the unrecovered investment in the contract as of any date is -

(A) the investment in the contract (determined without regard to subsection (c)(2)) as of the annuity starting date, reduced by

(B) the aggregate amount received under the contract on or after such annuity starting date and before the date as of which the determination is being made, to the extent such amount was excludable from gross income under this subtitle.

Code § 72(e) governs taxation when an annuity contract has not been annuitized and also defines "investment in the contract":

(1) *Application of subsection*.

(A) *In general*. This subsection shall apply to any amount which -

(i) is received under an annuity, endowment, or life insurance contract, and

(ii) is not received as an annuity,

if no provision of this subtitle (other than this subsection) applies with respect to such amount.

(B) *Dividends*. For purposes of this section , any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

(2) *General rule*. Any amount to which this subsection applies -

(A) if received on or after the annuity starting date, shall be included in gross income, or

(B) if received before the annuity starting date -

(i) shall be included in gross income to the extent allocable to income on the contract, and

(ii) shall not be included in gross income to the extent allocable to the investment in the contract.

(3) *Allocation of amounts to income and investment*. For purposes of paragraph (2)(B) -

(A) *Allocation to income*. Any amount to which this subsection applies shall be treated as allocable to income on the contract to the extent that such amount does not exceed the excess (if any) of -

(i) the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over

(ii) the investment in the contract at such time.

(B) Allocation to investment. Any amount to which this subsection applies shall be treated as allocable to investment in the contract to the extent that such amount is not allocated to income under subparagraph (A).

(4) *Special rules for application of paragraph (2)(B).* For purposes of paragraph (2)(B) -

(A) Loans treated as distributions. If, during any taxable year, an individual -

(i) receives (directly or indirectly) any amount as a loan under any contract to which this subsection applies, or

(ii) assigns or pledges (or agrees to assign or pledge) any portion of the value of any such contract,

such amount or portion shall be treated as received under the contract as an amount not received as an annuity. The preceding sentence shall not apply for purposes of determining investment in the contract, except that the investment in the contract shall be increased by any amount included in gross income by reason of the amount treated as received under the preceding sentence.

(B) Treatment of policyholder dividends. Any amount described in paragraph (1)(B) shall not be included in gross income under paragraph (2)(B)(i) to the extent such amount is retained by the insurer as a premium or other consideration paid for the contract.

(C) Treatment of transfers without adequate consideration.

(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.

(5) *Retention of existing rules in certain cases.*

(A) *In general.* In any case to which this paragraph applies -

(i) paragraphs (2)(B) and (4)(A) shall not apply, and

(ii) if paragraph (2)(A) does not apply,

the amount shall be included in gross income, but only to the extent it exceeds the investment in the contract.

(B) *Existing contracts.* This paragraph shall apply to contracts entered into before August 14, 1982. Any amount allocable to investment in the contract after August 13, 1982, shall be treated as from a contract entered into after such date.

(C) *Certain life insurance and endowment contracts.* Except as provided in paragraph (10) and except to the extent prescribed by the Secretary by regulations, this paragraph shall apply to any amount not received as an annuity which is received under a life insurance or endowment contract.

(D) *Contracts under qualified plans.* Except as provided in paragraph (8), this paragraph shall apply to any amount received -

(i) from a trust described in section 401(a) which is exempt from tax under section 501(a),

(ii) from a contract -

(I) purchased by a trust described in clause (i),

(II) purchased as part of a plan described in section 403(a),

(III) described in section 403(b), or

(IV) provided for employees of a life insurance company under a plan described in section 818(a)(3), or

(iii) from an individual retirement account or an individual retirement annuity.

Any dividend described in section 404(k) which is received by a participant or beneficiary shall, for purposes of this subparagraph, be treated as paid under a separate contract to which clause (ii)(I) applies.

(E) *Full refunds, surrenders, redemptions, and maturities.* This paragraph shall apply to -

(i) any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract, and

(ii) any amount received under a contract on its complete surrender, redemption, or maturity.

In the case of any amount to which the preceding sentence applies, the rule of paragraph (2)(A) shall not apply.

(6) *Investment in the contract*. For purposes of this subsection, the investment in the contract as of any date is -

(A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus

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

(7) *Repealed*.

(8) *Extension of paragraph (2)(B) to qualified plans*.

(A) *In general*. Notwithstanding any other provision of this subsection , in the case of any amount received before the annuity starting date from a trust or contract described in paragraph (5)(D), paragraph (2)(B) shall apply to such amounts.

(B) *Allocation of amount received*. For purposes of paragraph (2)(B) , the amount allocated to the investment in the contract shall be the portion of the amount described in subparagraph (A) which bears the same ratio to such amount as the investment in the contract bears to the account balance. The determination under the preceding sentence shall be made as of the time of the distribution or at such other time as the Secretary may prescribe.

(C) *Treatment of forfeitable rights*. If an employee does not have a nonforfeitable right to any amount under any trust or contract to which subparagraph (A) applies, such amount shall not be treated as part of the account balance.

(D) *Treatises Investment in the contract before 1987*. In the case of a plan which on May 5, 1986, permitted withdrawal of any employee contributions before separation from service, subparagraph (A) shall apply only to the extent that amounts received before the annuity starting date (when increased by amounts previously received under the contract after December 31, 1986) exceed the investment in the contract as of December 31, 1986.

(9) *Extension of paragraph (2)(B) to qualified tuition programs and Coverdell education savings accounts*. Notwithstanding any other provision of this subsection , paragraph (2)(B) shall apply to amounts received under a qualified tuition program (as defined in section 529(b)) or under a Coverdell education savings account (as defined in section 530(b)). The rule of paragraph (8)(B) shall apply for purposes of this paragraph.

(10) *Treatment of modified endowment contracts*.

(A) *In general*. Notwithstanding paragraph (5)(C) , in the case of any modified endowment contract (as defined in section 7702A) -

(i) paragraphs (2)(B) and (4)(A) shall apply, and

(ii) in applying paragraph (4)(A), “any person” shall be substituted for “an individual”.

(B) *Treatment of certain burial contracts*. Notwithstanding subparagraph (A), paragraph (4)(A) shall not apply to any assignment (or pledge) of a modified endowment contract if such assignment (or pledge) is solely to cover the payment of expenses referred to in section 7702(e)(2)(C)(iii) and if the maximum death benefit under such contract does not exceed $25,000.

(11) *Special rules for certain combination contracts providing long-term care insurance*. Notwithstanding paragraphs (2), (5)(C) , and (10), in the case of any 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 which is part of or a rider on such annuity or life insurance contract -

(A) the investment in the contract shall be reduced (but not below zero) by such charge, and

(B) such charge shall not be includible in gross income.

(12) *Anti-abuse rules*.

(A) *In general*. For purposes of determining the amount includible in gross income under this subsection -

(i) all modified endowment contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 modified endowment contract, and

(ii) all annuity contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 annuity contract.

The preceding sentence shall not apply to any contract described in paragraph (5)(D).

(B) *Regulatory authority*. The Secretary may by regulations prescribe such additional rules as may be necessary or appropriate to prevent avoidance of the purposes of this subsection through serial purchases of contracts or otherwise.

II.J.19.c. Code § 72(q) 10% Penalty for Early Distributions from Annuity Contracts

Code § 72(q) provides:

(1) *Imposition of penalty*. If any taxpayer receives any amount under an annuity contract, the taxpayer’s tax under this chapter for the taxable year in which such amount is

received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) *Subsection not to apply to certain distributions*. Paragraph (1) shall not apply to any distribution -

(A) made on or after the date on which the taxpayer attains age 59½,

(B) made on or after the death of the holder (or, where the holder is not an individual, the death of the primary annuitant (as defined in subsection (s)(6)(B))),

(C) attributable to the taxpayer's becoming disabled within the meaning of subsection (m)(7),

(D) which is a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary,

(E) from a plan, contract, account, trust, or annuity described in subsection (e)(5)(D),[2902]

(F) allocable to investment in the contract before August 14, 1982,

(G) under a qualified funding asset (within the meaning of section 130(d), but without regard to whether there is a qualified assignment),[2903]

(H) to which subsection (t) applies (without regard to paragraph (2) thereof),[2904]

(I) under an immediate annuity contract (within the meaning of section 72(u)(4)), or

(J) which is purchased by an employer upon the termination of a plan described in section 401(a) or 403(a) and which is held by the employer until such time as the employee separates from service.

(3) *Change in substantially equal payments*. If -

(A) paragraph (1) does not apply to a distribution by reason of paragraph (2)(D), and

(B) the series of payments under such paragraph are subsequently modified (other than by reason of death or disability) -

(i) before the close of the 5-year period beginning on the date of the first payment and after the taxpayer attains age 59½, or

(ii) before the taxpayer attains age 59½,

[2902] [my footnote:] Code § 72(e)(5)(D) applies to certain contracts under qualified plans.
[2903] [my footnote:] Code § 130(d) applies to certain annuities under certain personal injury assignments.
[2904] [my footnote:] Code § 72(t) applies to early distributions from qualified retirement plans.

the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(D)) would have been imposed, plus interest for the deferral period (within the meaning of subsection (t)(4)(B)).

II.J.19.d. Code § 72(s) Required Distributions Where Holder Dies Before Entire Interest Is Distributed

Code § 72(s) provides:

(1) *In general.* A contract shall not be treated as an annuity contract for purposes of this title unless it provides that -

(A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and

(B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.

(2) *Exception for certain amounts payable over life of beneficiary.* If -

(A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,

(B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

(C) such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe,

then for purposes of paragraph (1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distributions begin.

(3) *Special rule where surviving spouse beneficiary.* If the designated beneficiary referred to in paragraph (2)(A) is the surviving spouse of the holder of the contract, paragraphs (1) and (2) shall be applied by treating such spouse as the holder of such contract.

(4) *Designated beneficiary.* For purposes of this subsection , the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

(5) *Exception for certain annuity contracts.* This subsection shall not apply to any annuity contract -

(A) which is provided -

(i) under a plan described in section 401(a) which includes a trust exempt from tax under section 501, or

(ii) under a plan described in section 403(a),

(B) which is described in section 403(b),

(C) which is an individual retirement annuity or provided under an individual retirement account or annuity, or,

(D) which is a qualified funding asset (as defined in section 130(d), but without regard to whether there is a qualified assignment).

(6) *Special rule where holder is corporation or other non-individual.*

(A) *In general.* For purposes of this subsection, if the holder of the contract is not an individual, the primary annuitant shall be treated as the holder of the contract.

(B) *Primary annuitant.* For purposes of subparagraph (A), the term "primary annuitant" means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

(7) *Treatment of changes in primary annuitant where holder of contract is not an individual.* For purposes of this subsection , in the case of a holder of an annuity contract which is not an individual, if there is a change in a primary annuitant (as defined in paragraph (6)(B)), such change shall be treated as the death of the holder.

Code § 72(s)(2) looks a lot like parts of Code § 401(a)(9), but insurance company back offices do not apply the regulations under Code § 401(a)(9). If the beneficiary is not an actual individual, generally forget about stretching the payments (absent litigation against the insurance company to try to create favorable case law), notwithstanding the fact that a trust can be an individual. However, if the annuitant's surviving spouse is the beneficiary of a trust with an unlimited right to withdraw its income and principal, the surviving spouse is considered the beneficiary.[2905]

II.J.19.e. Annuity Contract Issued to Grantor Trust

For what is a grantor trust, see part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

Letter Ruling 202031008 involved the following:[2906]

> The Taxpayer is a life insurance company organized and operated under the laws of State. The Taxpayer is a subsidiary of the Parent and joins in the filing of a consolidated federal

[2905] Letter Ruling 200323012, Issue 1, analyzed in the text accompanying fn 2907 in part II.J.19.d Code § 72(s) Required Distributions Where Holder Dies Before Entire Interest Is Distributed. The grantor trust rules treat the surviving spouse as the deemed owner; see parts III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts and III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment.

[2906] The Non-Grantor Trust Scenario is evaluated in part II.J.19.f Annuity Contract Issued to Nongrantor Trust.

income tax return with the Parent on a calendar year basis using an accrual method of accounting.

The Taxpayer issues nonqualified deferred annuity contracts that may be fixed, indexed, or variable contracts, that contain customary, industry standard terms, and that are considered annuity contracts in accordance with the customary practice of life insurance companies (the "Contracts"). The Taxpayer regularly issues Contracts to both grantor trusts and non-grantor trusts in situations similar to those described below. The Taxpayer has information reporting obligations under section 6047(d) with respect to distributions or payments under the Contracts.

In the Grantor Trust Scenario, the Taxpayer issues a Contract to a grantor trust (*i.e.*, a trust described in subpart E of part I of subchapter J (sections 671 through 679)) (the "Grantor Trust") that was established by one individual (the "Grantor"). The beneficiaries of the Grantor Trust (each, a "Grantor Trust Beneficiary") are an individual who is not the Grantor and a charitable organization. There are no contingent beneficiaries under the Grantor Trust. The Grantor Trust is named in the Contract as the owner and beneficiary of the Contract (i.e., the person entitled to receive distributions under the Contract). The individual Grantor Trust Beneficiary is named in the Contract as the sole annuitant, the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract (i.e., the measuring life).

In the Non-Grantor Trust Scenario, the Taxpayer issues a Contract to a trust subject to tax under section 641 (the "Non-Grantor Trust") that was established by one individual (the "Settlor"). The sole beneficiary of the Non-Grantor Trust (the "Non-Grantor Trust Beneficiary") is an individual who is not the Settlor and who does not have a power exercisable by himself to vest trust income or corpus in himself as described in section 678. There are no contingent beneficiaries under the Non-Grantor Trust. The Non-Grantor Trust is named in the Contract as the owner and beneficiary of the Contract (i.e., the person entitled to receive distributions under the Contract). The Non-Grantor Trust Beneficiary is named in the Contract as the sole annuitant, the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract (*i.e.*, the measuring life).

Letter Ruling 202031008 involved the following representations:

1. In the Grantor Trust Scenario, the Grantor will be considered the owner of the entire Grantor Trust under subpart E of part I of subchapter J.

2. In the Non-Grantor Trust Scenario, neither the Settlor nor any other person will be considered the owner of the Non-Grantor Trust under subpart E of part I of subchapter J, and the Non-Grantor Trust is a trust subject to tax under section 641.

3. Each Contract is an annuity contract under the law of the jurisdiction where issued.

4. Each Contract qualifies for treatment as an annuity contract for federal income tax purposes, including by complying with the requirements of section 72(s) and, where applicable, the requirements of section 817(h) and the "investor control" doctrine.

5. The sole annuitant named in each Contract is the "primary annuitant" within the meaning of section 72(s)(6)(B).

6. No Contract will be issued in a situation where an employer is the nominal owner of the Contract and the employer's employees are the beneficial owners of the Contract, including as part of any arrangement to provide deferred compensation to such employees.

Letter Ruling 202031008 analyzed the Grantor Trust Scenario:

Sections 72(q)(2)(A), (C), (D)

Section 72(q) generally imposes an additional 10% tax on amounts received under an annuity contract that are includible in income unless certain exceptions apply. Sections 72(q)(2)(A), (C), and (D) respectively provide exceptions to the 10% additional tax if the distribution is made on or after the date the "taxpayer" attains age 59½, if the distribution is attributable to the "taxpayer's" becoming disabled, or if the distribution is part of a series of substantially equal periodic payments made for the life of the "taxpayer" or the "taxpayer" and his or her designated beneficiary. Section 7701(a)(14) defines "taxpayer" to mean any person subject to any internal revenue tax.

Under the grantor trust rules, section 671 provides that when the grantor is treated as the owner of any portion of a trust, the grantor must include in computing his or her taxable income those items of income, deductions, and credits that are attributable to that portion of the trust. Section 1.671-3(a)(1) provides, in relevant part, that if a grantor is treated as the owner of an entire trust, the grantor takes into account in computing his or her income tax liability all items of income to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as owner of the trust.

In the Grantor Trust Scenario, the Grantor is the owner of the Grantor Trust for federal income tax purposes. As a consequence, the Grantor is required to include in income any income arising from the receipt by the Grantor Trust of distributions under the Contract. Accordingly, the Grantor is the "taxpayer" with respect to the Contract, and references to the "taxpayer" in sections 72(q)(2)(A), (C), and (D) are references to the Grantor.

Section 72(q)(2)(B)

Section 72(q)(2)(B) provides an exception to the 10% additional tax if the distribution is made on or after the death of the "holder" or, when the "holder" is not an individual, the death of the primary annuitant (as defined in section 72(s)(6)(B)). Section 72(s)(6)(B) defines the primary annuitant as the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

In the Grantor Trust Scenario, the Grantor Trust is the "holder" of the Contract because it is designated in the Contract as the owner of the Contract. The Grantor Trust is not an individual, however, so the exception provided in section 72(q)(2)(B) applies if the distribution is made on or after the death of the primary annuitant, as defined in section 72(s)(6)(B). In the Grantor Trust Scenario, the primary annuitant is the individual Grantor Trust Beneficiary. Thus, the exception provided in section 72(q)(2)(B) will apply in the Grantor Trust Scenario to distributions made on or after the death of the individual Grantor Trust Beneficiary.

Section 72(u)(1)

Section 72(u)(1) generally provides that an annuity contract is not treated as such for federal income tax purposes (other than subchapter L) if it is held by a person who is not a natural person. The flush language of section 72(u)(1), however, provides that holding by a trust or other entity as an agent for a natural person is not taken into account for this purpose.

A trustee generally has fiduciary obligations under trust documents and governing law that are inconsistent with it acting as an agent for the beneficiary of a trust. See, *e.g.*, *Restatement (Third) of Agency section* 1.01 cmt. g (2018); *Restatement (Third) of Trusts* section 5(e) & cmt. e (2003); *Restatement (Second) of Agency* section 14B (1958). This principle also applies for federal income tax purposes. See, *e.g.*, Rev. Rul. 69-300; *United States v. Anderson*, 132 F.2d 98 (6th Cir. 1942). Accordingly, the phrase "as an agent" in the flush language of section 72(u)(1) pertains only to "other entity." It does not pertain to "trust." Thus, for purposes of section 72(u)(1), the holding of an annuity contract by a trust is not taken into account if the contract is held for a natural person.

In the Grantor Trust Scenario, the Grantor Trust is the "holder" of the Contract within the meaning of section 72(u)(1) because it is designated in the Contract as the owner of the Contract.

The Grantor is treated as the owner of the entire Grantor Trust, and as a consequence, the Grantor is also treated as the owner of the Contract for federal income tax purposes. See Rev. Rul. 85-13. The Grantor Trust is holding the Contract for the Contract's tax owner, the Grantor, who is a natural person. Accordingly, the holding of the Contract by the Grantor Trust is not taken into account for purposes of section 72(u)(1).

This determination is consistent with the purpose for adopting section 72(u). Section 72(u) was adopted to encourage employers to offer benefits to employees under qualified pension plans, which are subject to certain restrictions and generally must be made available to a wide class of employees, as opposed to offering deferred compensation to a limited class of employees that is funded by deferred annuity contacts. Because the Contract in the Grantor Trust Scenario is not issued in the employment context, the arrangement does not provide the sort of tax-favored benefit that section 72(u) was intended to limit.

Letter Ruling 202031008 ruled on the Grantor Trust Scenario:

(1) For purposes of section 72(q)(2), (i) the Grantor is the "taxpayer," so the exceptions in sections 72(q)(2)(A), (C), and (D) will apply based on the age, disability, and life or life expectancy, respectively, of the Grantor and (ii) the Grantor Trust is the "holder" of the Contract, so that the exception in section 72(q)(2)(B) will apply based upon the death of the primary annuitant (as defined in section 72(s)(6)(B)), who is the individual Grantor Trust Beneficiary.

(2) For purposes of section 72(u)(1) and pursuant to the flush language of that section, the Contract is held by the Grantor Trust for the Grantor, so that section 72(u)(1) will not apply even though one of the Grantor Trust Beneficiaries is a charitable organization.

When a joint revocable trust owns an annuity that is transferred to the surviving spouse's revocable share on the annuitant's death, the annuity is treated as owned by the surviving spouse and may be swapped in a Code § 1035 exchange. Letter Ruling 200323012 involved the following situation:

> Taxpayers A and B were married. On Date 4, Taxpayers A and B created Trust C, a revocable, inter vivos trust. Taxpayers A and B were the grantors, co-trustees, and beneficiaries of Trust C. The trust agreement provided that the survivor of Taxpayer A and Taxpayer B would be the surviving grantor/trustee and sole beneficiary of Trust C. Subsequently, Taxpayer A transferred ownership of two deferred variable Annuities (Contracts A and B) to Trust C and named Trust C the beneficiary of Contracts A and B. Taxpayer A died on Date 5 before the starting date of the Annuities.
>
> Trust C is an A/B type trust which, upon the first death of a grantor is to be divided into two subtrusts, "Subtrust D", a survivor's trust, and "Subtrust E", a credit shelter trust. Taxpayer B, as surviving grantor/trustee, has the power of allocation between the subtrusts of Trust C and is the trustee and beneficiary of both subtrusts. With respect to Subtrust E, Taxpayer B is entitled to all net income to that trust and can invade the principal on an unascertainable standard. Further, Taxpayer B has the right to withdraw the entire or any amount of income and/or principal from Subtrust D, and this right cannot be limited by trustee discretion.
>
> Taxpayer B, as surviving spouse, proposes to transfer Contracts A and B from Trust C to Subtrust D and exchange Contracts A and B for a new deferred variable annuity contract (Contract C). Contract C will be issued in favor of Taxpayer B. (Taxpayer B will be both owner and beneficiary.) At no point in the exchange will Subtrust D or Taxpayer B receive any money or property other than Contract C.

Letter Ruling 200323012 concluded that "Taxpayer B is the designated beneficiary of Contracts A and B within the meaning of section 72(s)(4),"[2907] reasoning:

> In this instance, although Trust C is the named holder and beneficiary of Taxpayer A's Annuities, Taxpayer B has the right to allocate funds between Subtrust D and Subtrust E upon the division of Trust C at Taxpayer A's death, and to withdraw all of the principal of Trust C from Subtrust D. Taxpayer B thus has complete control and dominion over Trust C and Subtrusts D and E, and over the disposition of the assets of Trust C and Subtrusts D and E. Taxpayer has represented that Trust C, Subtrust D and Subtrust E are grantor trusts for purposes of the Code and Income Tax Regulations. As a result, Taxpayer B is treated as the owner of the assets of Trust C, Subtrust D, and Subtrust E (including Contracts A and B). Under section 671, Taxpayer B must take into account items of income deductions and credits attributable to the assets of the trusts (including Contracts A and B).

The representation that the surviving spouse was the deemed owner of the credit shelter trust was simply wrong.[2908] However, the credit shelter trust never owned the annuity policy; instead,

[2907] See part II.J.19.d Code § 72(s) Required Distributions Where Holder Dies Before Entire Interest Is Distributed.
[2908] See part III.B.2.i.iii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?

the surviving spouse as trustee allocated it to the surviving spouse's revocable trust, so that representation was irrelevant (although presumably required by the IRS at that time).

Letter Ruling 200323012 ruled that the surviving spouse's revocable trust could, tax-free under Code § 1035,[2909] exchange both contracts on her life for an annuity contract that she owned:

> Section 1.1035-1(c) of the Income Tax Regulations provides that "section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured. The exchange, without recognition of gain or loss of an annuity contract for another annuity contract under section 1035(a)(3), is limited to cases where the same person or persons are the obligees under the contract received in the exchange as under the original contract."
>
> In this instance, although Trust C is nominally the obligee under Contracts A and B, as explained above, Taxpayer B is the owner of Contracts A and B for tax purposes and the designated beneficiary under section 72(s)(4). Taxpayer accordingly is the obligee of Contracts A and B within the meaning of section 1.1035-1(c) of the regulations. Because Taxpayer B will also be the obligee under Contract C, the same obligee requirement of section 1.1035-1(c) will be satisfied.
>
> The legislative history indicates that section 1035 was designed to eliminate the taxation of individuals "who merely exchanged one insurance policy for another better suited to their needs but who have actually recognized no gain." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 81 (1954). Thus, section 1035 operates as the insurance analogue to section 1031, which relates to like-kind exchanges of certain types of property held for productive use in a trade or business or for investment. The similarity of section 1031 and section 1035 is evidenced in section 1035(c)(1), which provides that the recognition of gain or loss on an exchange that is not solely like-kind will be made under the terms of section 1031(b) and (c). In addition, section 1035(c)(2) states that section 1031(d) provides rules relating to the basis of property acquired in an exchange described in section 1035(a). Section 1031(b), (c), and (d) similarly cross-reference section 1035(a).
>
> Section 1031 permits exchanges of one property for more than one property. See 1.1031(j)-1 (relating to exchanges of multiple properties). See also Rev. Rul. 85-135 1985-2 C.B. 181 (exchange of assets of two television stations for the assets of another television station); Rev. Rul. 73-476 1973-2 C.B. 300 (exchange of three undivided interests in three parcels of land for 100 percent ownership in one parcel).
>
> Because section 1035(a)(3) is written in the singular, one might argue that it does not apply to exchanges of one annuity for two annuities or exchanges of two annuities for one annuity contract. However, section 7701(m)(1) cross-references Title I, section 1 of the United States Code, which provides that "in determining the meaning of any Act of Congress, unless the context indicates otherwise, words importing the singular include and apply to several persons, parties, and things." Thus, just as section 1031 applies to exchanges of multiple properties, section 1035(a)(3) applies to exchanges of multiple annuities.

[2909] See part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.

II.J.19.f. Annuity Contract Issued to Nongrantor Trust

Letter Ruling 202031008 involved the following:[2910]

> In the Non-Grantor Trust Scenario, the Taxpayer issues a Contract to a trust subject to tax under section 641 (the "Non-Grantor Trust") that was established by one individual (the "Settlor"). The sole beneficiary of the Non-Grantor Trust (the "Non-Grantor Trust Beneficiary") is an individual who is not the Settlor and who does not have a power exercisable by himself to vest trust income or corpus in himself as described in section 678. There are no contingent beneficiaries under the Non-Grantor Trust. The Non-Grantor Trust is named in the Contract as the owner and beneficiary of the Contract (*i.e.*, the person entitled to receive distributions under the Contract). The Non-Grantor Trust Beneficiary is named in the Contract as the sole annuitant, the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract (*i.e.*, the measuring life).

Letter Ruling 202031008 analyzed the Non-Grantor Trust Scenario:

> Sections 72(q)(2)(A), (C), (D)
>
> As discussed above, sections 72(q)(2)(A), (C), and (D) provide exceptions to the 10% additional tax imposed by section 72(q)(1) if a distribution is made on or after the date the "taxpayer" attains age 59½, if the distribution is attributable to the "taxpayer's" becoming disabled, or if the distribution is part of a series of substantially equal periodic payments made for the life of the "taxpayer" or the "taxpayer" and his or her designated beneficiary.
>
> Unlike grantor trusts, a non-grantor trust is potentially subject to federal income tax. (Although the tax burden may be passed through to a non-grantor trust's beneficiaries, the non-grantor trust is initially subject to the tax and must claim a deduction to eliminate any income tax liability at the trust level.) In the Non-Grantor Trust Scenario, the Non-Grantor Trust is required to include in income any income arising from the receipt by the Non-Grantor Trust of distributions under the Contract. Accordingly, the Non-Grantor Trust is the "taxpayer" with respect to the Contract, and references to the "taxpayer" in sections 72(q)(2)(A), (C), and (D) are references to the Non-Grantor Trust.
>
> The Non-Grantor Trust, however, cannot attain age 59½, become disabled, or have a life expectancy, as contemplated by sections 72(q)(2)(A), (C), and (D), respectively. Thus, the exceptions provided by these provisions are not applicable to distributions under the Contract in the Non-Grantor Trust Scenario.
>
> Section 72(q)(2)(B)
>
> Section 72(q)(2)(B) provides an exception to the 10% additional tax if a distribution is made on or after the death of the "holder" or, when the "holder" is not an individual, the death of the primary annuitant (as defined in section 72(s)(6)(B)). Section 72(s)(6)(B) defines the primary annuitant as the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract.

[2910] For essential background, please read fn 2906 (not just the first indented portion but also the numbered representations that follow it) in part II.J.19.e Annuity Contract Issued to Grantor Trust.

In the Non-Grantor Trust Scenario, the Non-Grantor Trust is the "holder" of the Contract because it is designated in the Contract as the owner of the Contract. The Non-Grantor Trust is not an individual, however, so the exception provided in section 72(q)(2)(B) applies if the distribution is made on or after the death of the primary annuitant, as defined in section 72(s)(6)(B). In the Non-Grantor Trust Scenario, the primary annuitant is the Non-Grantor Trust Beneficiary. Thus, the exception provided in section 72(q)(2)(B) will apply in the Non-Grantor Trust Scenario to distributions made on or after the death of the Non-Grantor Trust Beneficiary.

Section 72(u)(1)

As discussed above, for purposes of section 72(u)(1), the holding of an annuity contract by a trust is not taken into account if the contract is held for a natural person.

In the Non-Grantor Trust Scenario, the Non-Grantor Trust is the "holder" of the Contract because it is designated in the Contract as the owner of the Contract.

In the Non-Grantor Trust Scenario, the Non-Grantor Trust Beneficiary is the only beneficiary of the trust and the only person who will benefit from the distributions under the Contract. Thus, the Non-Grantor Trust is holding the Contract for the benefit of the Non-Grantor Trust Beneficiary, a natural person. Accordingly, the holding of the Contract by the Non-Grantor Trust is not taken into account for purposes of section 72(u)(1).

This determination is consistent with the purpose for adopting section 72(u), which was discussed above. Because the Contract in the Non-Grantor Trust Scenario is not issued in the employment context, the arrangement does not provide the sort of tax-favored benefit that section 72(u) was intended to limit.

Letter Ruling 202031008 ruled on the Non-Grantor Trust Scenario:

(1) For purposes of section 72(q)(2), (i) the Non-Grantor Trust is the "taxpayer," so that the exceptions in sections 72(q)(2)(A), (C), and (D) will not apply to any distribution from the Contract because the Non-Grantor Trust cannot attain age 59½, become disabled, or have a life or life expectancy within the meaning of such sections and (ii) the Non-Grantor Trust is the "holder" of the Contract, so that the exception in section 72(q)(2)(B) will apply based upon the death of the primary annuitant (as defined in section 72(s)(6)(B)), who is the Non-Grantor Trust Beneficiary.

(2) For purposes of section 72(u)(1) and pursuant to the flush language of that section, the Contract is held by the Non-Grantor Trust for the Non-Grantor Trust Beneficiary, so that section 72(u)(1) will not apply.

In other words, in most cases the 10% penalty for early distribution under part II.J.19.c Code § 72(q) 10% Penalty for Early Distributions from Annuity Contracts applies unless the contract is an immediate annuity contract or to the extent that payments are received after the sole beneficiary's death.

For post-mortem trust funding, see Letter Ruling 200323012, described in part II.J.19.e Annuity Contract Issued to Grantor Trust.

II.J.19.g. Loss on Sale of Annuity

Rev. Rul. 61-201 addresses "the method of computing the basis of a single premium refund annuity contract for the purpose of determining the amount of loss sustained by the original purchaser upon his surrender of the annuity contract for a cash consideration." In that case:

> The taxpayer purchased a single premium refund annuity policy for 25x dollars. In 1956, he surrendered the policy for a cash consideration of 10x dollars. The annuity payments received during prior years totaled 15x dollars of which 7x dollars were excluded from gross income under the law applicable at the time of receipt.

Citing Reg. § 1.72-11(d)(1), Rev. Rul. 61-201 reasoned and held:

> It is clear that the contract under consideration is one to which section 72 of the Code applies and that the 10x dollars received by the taxpayer, upon surrender of the contract, was "an amount not received as an annuity" under section 72(e) of the Code. It is likewise clear that, where the transaction results in a loss, the same treatment should be afforded the taxpayer as is afforded where the transaction results in a gain. Further, the amount of 7x dollars excluded from gross income in the instant case merely represents a recovery of "basis" (investment) for which adjustment is required under section 1016(a)(1) of the Code, which provides, as far as here pertinent, that proper adjustment in respect of property shall in all cases be made for receipts properly chargeable to capital account.
>
> Accordingly, in determining the amount of loss sustained in the instant case by the original purchaser upon his surrender of a single premium refund annuity contract for a cash consideration, the basis of the contract is its cost (25x dollars) less the amounts previously received under the contract which were properly excludable from the gross income of the recipient under the law applicable at the time of receipt (7x dollars). The excess of the basis thus determined (18x dollars) over the amount received upon surrender of the contract (10x dollars) constitutes an ordinary loss (8x dollars).
>
> I.T. 3567, *supra*, is modified to remove therefrom the implication that the entire amounts of the annuity payments received by the annuitant are deducted from his cost of the annuity contract in computing the amount of loss sustained upon its surrender.
>
> Nothing in this ruling should be construed as permitting a loss deduction on the surrender of any contract other than a refund annuity.

However, Code § 72(b)(3), "Deduction where annuity payments cease before entire investment recovered," provides:[2911]

> (A) *In general*. If-
>
> (i) after the annuity starting date, payments as an annuity under the contract cease by reason of the death of an annuitant, and
>
> (ii) as of the date of such cessation, there is unrecovered investment in the contract,

[2911] This deduction is not a miscellaneous itemized deduction. See fn 1395 in part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.

the amount of such unrecovered investment (in excess of any amount specified in subsection (e)(5) which was not included in gross income) shall be allowed as a deduction to the annuitant for his last taxable year.

(B) *Payments to other persons*. In the case of any contract which provides for payments meeting the requirements of subparagraphs (B) and (C) of subsection (c)(2) , the deduction under subparagraph (A) shall be allowed to the person entitled to such payments for the taxable year in which such payments are received.

(C) *Net operating loss deductions provided*. For purposes of section 172 , a deduction allowed under this paragraph shall be treated as if it were attributable to a trade or business of the taxpayer.

Both Rev. Rul. 61-201 and Code § 72(b)(3) seem to involve only dealings between the contract holder and the issuer. Presumably an annuity contract would be a capital asset, given that a life insurance contract, which is also taxed under Code § 72, is a capital asset.[2912] An annuity contract is not excluded from the definition of "capital asset" under Code § 1221.

II.J.19.h. Comparing Annuity to Life Insurance

The preceding subparts within this part II.J.19 Trusts Holding Annuities explain that any income or growth in an annuity contract generally will be taxed at the earliest moment when the contract distributes cash, with the only recovery of basis occurring either when the annuity is annuitized, cashed out, or when all of the income has already been paid. Furthermore, a nongrantor trust will often pay a 10% penalty on distributions before the beneficiary's death; a nongrantor trust might be able to hold an annuity when it has more than one beneficiary, but whether the 10% penalty applies when a distribution is made after one beneficiary's death may be unclear. An annuity does not receive a basis step-up when passing by reason of death.[2913]

Contrast this with a life insurance contract, from which in most cases distributions are not taxable until after basis is applied to prior distributions. See part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy). Furthermore, unless certain rules are violated, death benefits are free from income tax. See parts II.Q.4.b Transfer for Value Rule; Basis and II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies.

Life insurance contracts are the only assets for which generally I'm comfortable not requiring any payments with respect to financing arrangements before maturity. See part II.Q.4.f Split-Dollar Arrangements.

As described in part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035, a life insurance contract may be swapped tax-free into another life insurance, endowment, annuity, or qualified long-term care insurance contract, but an annuity contract may be swapped tax-free only into another annuity or qualified long-term care insurance contract.

[2912] Rev. Rul. 2009-13, described in fn. 4172 in part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.
[2913] Code § 1014(b)(9)(A).

Based on a variety of rulings found in part II.Q.4.i.ii.(a) Trust Ownership of Policy (which is found within part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity):

- If a trust holds insurance on the trustee's life, the life insurance is included in the insured's taxable estate unless the trustee is screened from all incidents of ownership.
- If a trust holds insurance on a beneficiary's life, the IRS might take the position that life insurance is included in the insured's taxable estate.[2914]
- Looking instead to part II.Q.4.i.ii.(c) Partnership Ownership of Policy: If the trust invests in a partnership that owns life insurance, neither of the above concerns should be an issue. In terms of long-term flexibility, transfers of the life insurance contract itself may raise issues,[2915] but transfers of or changes in partnership interests should not.[2916] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance for why and how the partnership should obtain the insured's consent to the life insurance policy. Also see part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule if the partnership transfers the policy.

Note also that an annuity contract includes an person whose life is insured; if the contract's investments are less than premiums at the insured's death, the contract boosts its value to premiums paid. I have not researched whether this feature may cause estate inclusion.

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

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

If life insurance policies can be transferred among the shareholders or from the corporation to the shareholders, the transfer for value rules must be examined. The transfer-for-value rule states that, if consideration is given for the transfer of an insurance policy, then the proceeds of the policy will be taxed as income to the owner-beneficiary upon the insured's death.[4100] Specifically:[4101]

> 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,[4102] 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

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[2914] See text accompanying and preceding fn 4377 in part II.Q.4.i.ii.(a) Trust Ownership of Policy.
[2915] See part II.Q.4.b Transfer for Value Rule; Basis.
[2916] See part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance.
[4100] 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.
[4101] Reg. § 1.101-1(f)(5).
[4102] 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

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;[4103] 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.[4104]

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)[4105] – as a transfer for valuable consideration. Also, Reg. § 1.101-1(g)(10), Example 10 assumes that a transfer to a corporation is a transfer for value.

The transfer for value rule does not apply to transfers made to the insured, a corporation in which the insured is an officer or stockholder, a partner of the insured,[4106] a partnership in which the

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> 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.

[4103] 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).

[4104] *James F. Waters, Inc. v. Commissioner*, 160 F.2d 596 (9th Cir. 1947) (prior version of this statute).

[4105] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4106] 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.

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.[4107] This exception looks at the deemed owner of a grantor trust.[4108] A

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.

[4107] Code § 101(a)(2)(A), (B).

[4108] Rev. Rul. 2007-13 posited the following situations:

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

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

It held:

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

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

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

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

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

The movement of the life insurance contracts from the AC Trust to the AB Trust has two aspects. The first aspect is that, pursuant to the rationale of Rev. Rul. 85-13, Individual A, as a grantor of the AC Trust, as amended, proposes to transfer the life insurance contracts to the AB Trust of which Individual A is the grantor. Thus, this aspect of the transaction cannot be recognized as a sale or exchange for tax purposes because Individual A is treated for income tax purposes as owning the

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.[4109] 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.[4110] Similarly, contributing a life insurance policy to a partnership in a Code § 721 nontaxable transfer[4111] is a substituted basis transaction that is not subject to the original transfer for value rules[4112] but may need to be checked under the reportable policy sale rule under part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

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

Special rules apply to a "reportable policy sale," which is "the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract."[4113] "Indirectly" includes "the acquisition of an interest in a partnership, trust, or other

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> 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.

[4109] 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.

[4110] 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.

[4111] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4112] Letter Ruling 201308019.

[4113] Code § 101(a)(3)(B).

entity that holds an interest in the life insurance contract."[4114] 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.[4115] Thus, the death benefit generally is taxable, to the extent described in fn 4100.
- Various reporting requirements apply when the death benefit is paid.[4116]

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 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)),

[4114] Code § 101(a)(3)(B).
[4115] Code § 101(a)(3)(A).
[4116] Code § 6050Y, which is reproduced in part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.

> 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.[4117]

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

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

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

> Generally, amounts received under a life insurance contract that are paid by reason of the death of the insured are excluded from federal income tax under section 101(a)(1). However, if a life insurance contract is sold or otherwise transferred for valuable consideration, the "transfer for value rule" set forth in section 101(a)(2) limits the excludable portion of the amount paid by reason of the death of the insured. Section 101(a)(2) provides that the excludable amount following a transfer for valuable

[4117] For more about these nuances, see part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance, especially fn 4162.

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).[4118]
>
> (2) *Cross references.* For rules governing the taxability of insurance proceeds constituting benefits payable on the death of an employee -

[4118] [my footnote:] For Code § 101(j), see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

(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.

Section 1.101-1(b)(1)(i) of the proposed regulations provides the general transfer for value rule set forth in section 101(a)(2). Section 1.101-1(b)(1)(ii) of the proposed regulations sets forth the exceptions from this general rule for transfers for valuable consideration that are not reportable policy sales (the certain person exception and carryover basis exception provided in section 101(a)(2)). Section 1.101-1(b)(2) of the proposed regulations provides rules regarding gratuitous transfers of interests in life insurance contracts, as well as transfers of only a part of an interest in a life insurance contract and bargain sales of an interest in a life insurance contract (that is, transfers that are in part gratuitous and in part transfers for valuable consideration). This section of this Summary of Comments and Explanation of Revisions discusses comments received on § 1.101-1(b) of the proposed regulations.

A. Transfers to certain persons

One commenter on the proposed regulations described a life insurance policy subject to the section 101(a)(2) transfer for value rule as "tainted," in that death benefits paid under the policy are no longer fully excluded from income under section 101(a)(1). The commenter asked that the final regulations provide for removal of the "taint" by a transfer to the insured, as was permitted before the TCJA, and asked for clarification regarding whether a transfer of a policy to the insured must be a sale for fair market value to remove the "taint" of a transfer for valuable consideration. The commenter suggested that mistakes happen, including the mistake of not seeking tax advice from a professional who knows the section 101 rules, and that taxpayers should be able to take corrective measures to remove this "taint." The commenter noted that the insured may no longer have a business or other need for the current transferee to own the policy and may wish to hold the policy to protect the insured's family, or the insured may regret selling the policy and wish to buy the policy back after the policy was transferred in a reportable policy sale. The commenter pointed out that § 1.101-1(b)(3)(ii) of the existing regulations (not yet revised to reflect TCJA changes to section 101) currently provides such a corrective measure, allowing the "taint" to be removed by a transfer of the policy to certain persons. However, § 1.101-1(b)(1)(ii)(B)(2) of the proposed regulations makes this corrective measure unavailable to the extent that the transfer to those certain persons was preceded by a transfer of the policy for valuable consideration in a reportable policy sale. The commenter also noted that § 1.101-1(b)(3)(ii) of the existing regulations does not require the corrective transfer to be a sale for fair market value, and that § 1.101-1(b)(1)(ii)(B)(*1*) 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.[4119]

Section 1.101-1(b)(1)(ii)(B)(*l*) 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 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

[4119] [My footnote:] I was that commenter.

of the proceeds attributable to such policy or interest that is excludable from the transferee's gross income under section 101(a) is, as a general rule, limited to the sum of the amount which would have been excludable by the transferor if no such transfer had taken place and any premiums and other amounts subsequently paid by the transferee with respect to the interest. However, if the gratuitous transfer in question is made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, the entire amount of the proceeds attributable to the policy or interest transferred is excludable from the transferee's gross income.

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

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

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

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

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

insurance contract is transferred gratuitously to the insured, and that interest has not previously been transferred for value in a reportable policy sale, the entire amount of the proceeds attributable to the interest transferred to the insured is excludable from gross income.

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

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

"Gratuitous" is not defined anywhere, but the context of Reg. § 1.101-1(b)(2) suggests that it means any transfer that is not for valuable consideration. Reg. § 1.101-1(f)(5), reproduced in the text accompanying fn 4101, 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)[4120] – 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.[4121]

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

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

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

The preamble to the proposed regulations explains:[4122]

> 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

[4120] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
[4121] Especially text accompanying fn 4157, as well as Example (2) that is discussed in the text accompanying fn 4151.
[4122] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

> in 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 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[4123]

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

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

Another commenter recommended that the statement in § 1.101-1(e)(2) of the proposed regulations regarding section 1035 exchanges be deleted or amended to eliminate any suggestion that such transactions, by themselves, can lead to reportable policy sales. The

[4123] [My footnote – not in the preamble:] For why this exception may be perceived to be too narrow, see text accompanying fn 4134 in part II.Q.4.b.ii.(c) "Reportable Policy Sale".

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. § 1.101-1(e)(1), "Definition," provides:[4124]

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

[4124] 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 4161.

> the life insurance contract generally is the owner (or an owner) of the contract and holds an interest in the contract.

Reg. § 20.2042-1(c)(2) is reproduced in the text accompanying fn 4370 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:[4125]

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

[4125] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

Reg. § 1.101-1(e)(3), "Acquisition of an interest in a life insurance contract," provides:[4126]

> 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:[4127]

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

[4126] For the significance of indirect acquisitions under Reg. § 1.101-1(e)(3)(ii), see text accompanying fn 4163 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 4133 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.
[4127] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

Reg. § 1.101-1(f)(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 1726.

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[4128] and for whether certain reporting must be done.[4129]

[4128] 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.
[4129] See part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.

The preamble to the proposed regulations explains:[4130]

> 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:[4131]

> 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:[4132]

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

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

> Under section 101(a)(3)(B) and § 1.101-1(c)(1) of the proposed regulations, a reportable policy sale is, as a general matter, any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract. Exceptions to the definition of reportable policy sale for transfers between certain related entities are provided in § 1.101-1(c)(2)(i) and (ii) of the proposed regulations. Section 1.101-1(c)(2)(iii) of the proposed regulations sets forth exceptions from the definition of reportable policy sales for certain indirect acquisitions. This section

[4130] 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."
[4131] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4126 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.
[4132] 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."

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:[4133]

(i) A transfer of an interest in a life insurance contract between entities with the same beneficial owners, if the ownership interest of each beneficial owner in the transferor entity does not vary by more than a 20 percent ownership interest from that beneficial owner's ownership interest in the transferee entity. In a series of transfers, the prior

[4133] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4126 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

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.[4134] 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.)[4135]

Reg. § 1.101-1(c)(2)(i) refers to Reg. § 1.101-1(g)(13),[4136] 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)[4137] elaborates on Reg. § 1.101-1(c)(2)(iii)(B), providing:

> *Example 15*. The facts are the same as in Example 14[4138] in paragraph (g)(14) of this section, except that A is no longer an employee of Partnership X, and Partnership X has no substantial family, business, or financial relationship with A, when B acquires the profits interest in Partnership X. Also, B acquires only a 5% profits interest in exchange for a cash payment of $500,000. Partnership X does not own an interest in any other life insurance policies, and the gross value of its assets is $10 million. Although neither Partnership X nor B has a substantial family, business, or financial relationship with A at the time of B's indirect acquisition of an interest in the policy covering A's life, because B's profits interest in Partnership X does not exceed 5%, and because no more than 50% of Partnership X's asset value consists of life insurance contracts, the exception in paragraph (c)(2)(iii)(B) of

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4134 For the preamble discussing this issue, see fn 4123 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

4135 See Reg. § 1.101-1(d)(2)(ii).

4136 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....

4137 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....

4138 [Not in the regulation - click to go to:] Example 14.

> 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:[4139]

> 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.
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> Comments received on Notice 2018-41 suggested that acquisitions of life insurance contracts, or interests therein, in certain ordinary course business transactions involving the acquisition of a trade or business should not be considered reportable policy sales, including ordinary course business transactions whereby one trade or business acquires another trade or business that owns life insurance on the lives of former employees or directors. The definition of substantial business relationship in § 1.101-1(d)(2) of the proposed regulations, as well as certain other provisions in the proposed regulations, are intended to exclude certain of these transactions from the definition of reportable policy sales.
>
> Section 1.101-1(d)(3) of the proposed regulations describes the three situations in which a substantial financial relationship exists between the insured and the acquirer: (1) The acquirer (directly or indirectly, through one or more partnerships, trusts, or other entities of which it is a beneficial owner) has, or the beneficial owners of the acquirer have, a common investment (other than the interest in the life insurance contract) with the insured

[4139] 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."

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.[4140] The Treasury

[4140] [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-

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."[4141] 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 the charitable organization's services in some manner.[4142] 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

comments.pdf. Discussing with ACTEC Fellow Michael Van Cise's the comment he was making below got me thinking more about this issue.

[4141] [my footnote:] ACTEC Fellow Michael Van Cise was that commenter.

[4142] [my footnote:] I was that commenter; see fn 4140.

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.

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 4089-4091 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)[4143] 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

[4143] 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....

> 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)[4144] 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 reportable policy sale under paragraph (c)(1) of this section, unless an exception set forth in paragraph (c)(2) of this section applies.

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

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

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

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

[4144] 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 preamble to the proposed regulations explains:[4145]

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

[4145] 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."

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.[4146]

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.[4147]

Examples (10) through (12) in Reg. § 1.101-1(g)(10) through(12)[4148] 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

[4146] Reg. § 1.101-1(b)(1)(ii)(B)(1) is applied is Example (3), which is discussed in the text accompanying fn 4152 in part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.
[4147] Especially text accompanying fn 4156.
[4148] 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....

paragraph (b)(1)(ii)(B) of this section are satisfied. Accordingly, paragraph (b)(1)(ii)(B) of this section applies, and paragraph (b)(1)(ii)(A) of this section is inapplicable. Under paragraph (b)(1)(ii)(B)(*l*) of this section, Corporation X's exclusion is not limited by paragraph (b) of this section.

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

(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)[4149] describe how to cleanse a policy:

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

(2) *Example 2.* The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B gratuitously transfers the policy back to A. A's estate receives the proceeds of $100,000 on A's death. Because the transfer from B to A is 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)(*I*) 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.[4150]

[4149] 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....

[4150] See Rev. Rul. 2007-13, reproduced in fn 4108 in part II.Q.4.b.i Transfer for Value Rule Generally.

Example (2) cleansed the policy by a gratuitous transfer to the insured under Reg. § 1.101-1(b)(2)(i).[4151]

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).[4152] 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)[4153] in the proposed regulations asserted that no transfer back to the insured will cleanse the policy from the transfer for value rules, but the final regulations allow a fair market value sale to the insured to cleanse the policy:

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

(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

[4151] Fn 4157 reproduces the relevant part of . § 1.101-1(b)(2)(i), and Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn 4121 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

[4152] See text accompanying and preceding fn 4146 in part II.Q.4.b.ii.(d) Transfer With Substituted Basis or To Permitted Transferee When Not a Reportable Policy Sale.

[4153] 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....

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)[4154] applies the bargain sale rule to Example (6):

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

(i) *Treatment of policy interest purchased by A.* A's estate may exclude from income all of the policy proceeds related to the 50% policy interest transferred for valuable consideration ($50,000) because, under paragraph (b)(1)(ii)(B)(3)(i) of this section, 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)[4155]:

(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,

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[4154] 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....

[4155] 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

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

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

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

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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....

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.[4156] 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

[4156] Reg. § 1.101-1(b)(1)(ii)(B)(3) is reproduced in the text preceding fn 4147.

income."[4157] And that cleansing can apply to subsequent transferees, when appropriate. I am delighted that, in response my comments, the final regulations provide both of these cleansing opportunities.

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

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

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

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

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

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

> (1) *In general*. Every person who acquires a life insurance contract or any interest in a life insurance contract in a reportable policy sale during any taxable year shall make a

[4157] Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn 4121 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

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).[4158]

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).[4159]

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

[4158] [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).
[4159] [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).

any interest therein."[4160] Code § 101(a)(3)(A) added that the permitted transfer and permitted transferee exceptions to the transfer for value rule "shall not apply in the case of a transfer of a life insurance contract, or any interest therein, which is a reportable policy sale." Code § 101(a)(3)(B) defines a "reportable policy sale" as "the acquisition of an interest in a life insurance contract, directly or indirectly," if the acquirer does not have a required connection to the insured.

As described in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract, Reg. § 1.101-1(e)(1), "Definition,"[4161] 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."[4162] 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.[4163] 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:[4164]

> 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

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[4160] Code § 101(a)(2).

[4161] Reg. § 1.101-1(e)(1) is reproduced in the text accompanying fn 4124.

[4162] For a discussion of legislative history supporting this idea, see fn 4117 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

[4163] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4126 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 4133 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

[4164] 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 4133 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

contracts.[4165] Otherwise, one may need to file Form 1099-LS for each policy, to qualify for the exception for a reportable policy sale reported in compliance with Code § 6050Y(a) and Reg. § 1.6050Y-2.

Although I feel comfortable taking the position that the rule regarding indirect acquisitions does not cause the transfer of an interest in a business entity to be a transfer for value, the IRS might assert that such a position makes the reportable policy sale rule toothless for income tax purposes, because all one needs to do to protect a life insurance contract from the income tax consequences is to put the life insurance in a partnership wrapper. Thus, the IRS' might argue that an "indirect acquisition" constitutes a "a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein."[4166]

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

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

Rev. Rul. 2009-13 took the position that the basis of a policy that is sold to a person other than the issuer is not equal to the premiums paid.[4167] 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,[4168] 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).[4169]

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.

[4165] 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 4133 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

[4166] Code § 101(a)(2).

[4167] See Rev. Ruls. 2009-13 and 2009-14. Commentators disagreed with the IRS' position.

[4168] 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.

[4169] For details on Rev. Rul. 2020-5, see text accompanying fn 4174.

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

(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. § provides, "section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured."[4170] Rev. Rul. 90-109 examined a contract that allowed the insured to change (highlighting added):

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

It held:

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

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

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[4170] 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.

> 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.[4171]

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 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.

[4171] Letter Ruling 200323012 is discussed (including large excerpts) in part II.J.19.e Annuity Contract Issued to Grantor Trust in the text before and after fn 2909.

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:[4172]

[4172] 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.

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Law and Analysis

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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 4174.]

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

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"),[4173] 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.[4174]

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taxpayer cannot be converted into capital gain by a sale or exchange. *See also Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004); *Davis v. Commissioner*, 119 T.C. 1 (2002) (applying the substitute for ordinary income doctrine after the Arkansas Best decision).

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

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

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

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

[4173] 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. 4189.

[4174] See text accompanying fn 4169 in part II.Q.4.b.iii Basis in Purchased Life Insurance Contract. Thus, Rev. Rul. 2020-5 modifies the analysis of fn 4172:

> 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).

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.[4175] 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.[4176]

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,[4177] the rules described below do not apply.[4178]

Generally, distributions (other than tax-free death benefits) from life insurance contracts are not taxable "the extent allocable to the investment in the contract."[4179] Dividends used to pay premiums are not taxable.[4180] 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[4181] and are treated as distributions when those exceptions apply.[4182] 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.[4183]

Any distributions in excess of "investment in the contract" constitute ordinary income.[4184] However, Code § 1234A might be used to argue that income on surrender should be all capital gain.[4185]

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.

[4175] Rev. Rul. 2009-13, Situation 1.

[4176] 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.

[4177] Code § 101(a)(1).

[4178] 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.

[4179] Code §§ 72(e)(1), 72(e)(2)(B)(ii).

[4180] Code § 72(e)(4)(B).

[4181] Code § 72(e)(4)(A) includes various exceptions.

[4182] Code § 72(e)(4)(A) includes various exceptions.

[4183] Code § 72(e)(10), using the definition of modified endowment contract in Code § 7702A.

[4184] Code § 72(e)(2).

[4185] 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.

"Investment in the contract":[4186]

as of any date is-

(A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus

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

However, charges relating to a long-term insurance component of a policy may reduce "investment in the contract."[4187]

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

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[4186] Code § 72(e)(6).

[4187] 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).

starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

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

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

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

Consider the following potential abuse:

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

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

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

Given that the buyer has no risk, a policy owner could easily find a straw man to help the policy owner cash in the policy and receive capital gain treatment, avoiding the ordinary income treatment provided by Code § 72(e)(1). Rev. Rul. 2009-13,[4188] Situation 2,[4189] 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.[4190]

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[4191] if the buyer expects to receive death benefit in excess of investment in the contract.

[4188] See fn 4168 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.
[4189] See fn. 4172.
[4190] See text accompanying fn. 4172.
[4191] Code § 101(a)(2).

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[4192]) receives a new tax basis when that individual dies if that property is included in that individual's estate for estate tax purposes.[4193]

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

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

However, "annuities described in section 72" do not receive a new basis.[4194] 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.[4195] Regulations provide:[4196]

> **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."[4197] 2017 tax reform

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[4192] 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.

[4193] Code § 1014, which applies to more than just what this sentence describes.

[4194] Code § 1014(b)(9); Reg. § 1.1014-2(b)(3)(i).

[4195] Code § 1014(c).

[4196] Reg. § 1.691(a)-1(b).

[4197] 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.

modified this test; a brief explanation is in the "SUPPLEMENTARY INFORMATION" portion of the preamble to T.D. 9941 (1/6/2021):

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 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."[4198]

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)[4199] or excluded from income (if received as a

[4198] Reg. § 1.691(a)-1(c).
[4199] Code § 72(e).

nontaxable death benefit).[4200] In other words, it is not true that "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Therefore, the inside build-up has not "accrued" upon that owner's death and cannot constitute IRD.

This analysis is consistent with a test the Tax Court formulated for determining whether proceeds from a sale contract are IRD. The test considers:[4201]

[4200] See fns. 4177-4178.

[4201] *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

(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

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section 121, with respect to the sale of the residence described herein. However, if the executor chooses not to make the election under section 121, or to the extent that the gain exceeds the amount excludable under section 121, the provisions of section 691(a), relating to income in respect of a decedent, will apply. Rev. Rul. 78-32.

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

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

> decedent's death are incomplete "only as to delivery of the *res* and receipt of the purchase price").
>
> [7] *Cf. Keck v. Commissioner*, *supra* 415 F.2d at 534 (sale of stock was contingent upon Interstate Commerce Commission approval; proceeds held not income in respect of decedent where ICC approval not granted at time of the decedent's death).
>
> [8] *See* 26 C.F.R. § 1.691(a)-2(b) (Ex. 4) (buy-sell agreement effective at date of death; proceeds not income in respect of a decedent because the decedent could not have received the proceeds if he had lived).

The Tax Court in that case held:[4202]

> 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:[4203]

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

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

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

Insurance companies remain concerned because they view the inside build-up as vested untaxed earnings. Although this argument seems untenable for contracts whose cash value might later decrease, for fully paid whole-life they understandably view it as absolute earnings that will never

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[4202] 74 T.C. at 643-44.

[4203] 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.

decrease. Rev. Rul. 2009-13[4204] 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.[4205] 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),[4206] 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"[4207] 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.[4208] 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,[4209] so my mention of it simply provides context in which to analyze these issues.

[4204] See fn 4168 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.

[4205] See fn. 4172.

[4206] Code § 1221(a)(1) provides:

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

Note that real estate might or might not constitute inventory. See part II.G.14 Future Development of Real Estate, especially fn. 1547.

[4207] 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.

[4208] 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. 2019, found in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[4209] See fn 4168 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.[4210]

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[4211] do not make the death benefit taxable.[4212]

Before buying a cash value policy to be includible in the estate of a person who is not the insured or that might be transferred in a taxable sale (perhaps one that avoids the transfer for value rules), consider asking the insurance company its procedures in this area. Results from that inquiry include the following:

- "We never undertake to make a Code § 72(g) adjustment, because we don't want to be bothered with it." If the insurance company answers that way, ask whether they will honor a request to check the box "taxable amount not determined" so that the taxpayer is not required to disprove what otherwise would be an incorrect Form 1099.
- "We don't want to undertake to make a Code § 72(g) adjustment, but we will do it if a sale violates the transfer for value rules; in that case, we need to tell the IRS the taxable amount at death, so it is worth it to track this." To obtain that Form 1099 reporting, the policy owner's estate might sell the policy in a transaction that violates the transfer for value rules. One might follow that transfer by a transfer to the insured, which would cleanse the transfer for value taint (perhaps other cleansing opportunities are available as well). For example, Dad owns

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[4210] Rev. Rul. 75-125 (which the Rev. Rul. 92-47 cited as being good law) took the position that stock, which has net unrealized appreciation (NUA) that was not taxed when distributed from a qualified retirement, does not receive a basis step-up at death to the extent of that NUA. This ruling preceded *Peterson* (fn. 4201), 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.

[4211] See part II.Q.4.a Funding the Buy-Sell, especially fns. 4100-4112.

[4212] 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.

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.i. Life Insurance LLC

Wouldn't it be nice to avoid using a lot of policies, minimize life insurance income tax consequences to owners coming and going,[4368] 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 proceeds are used as intended. Each owner would have an interest in policies insuring the other partners' lives. I obtained Letter Ruling 200747002, which approved such a strategy.

II.Q.4.i.i. The Facts of Letter Ruling 200747002

The flowcharts in the Appendices A and B illustrate the situation. Appendix A illustrates trusts that were set up. Appendix B explains the Insurance LLC's structure. Appendix C illustrates some creative planning described below.

In this case, an S corporation had three shareholders: Child A (Brother), Child B (Sister), and BA. BA was an unrelated shareholder. Although the ruling does not disclose the percentage ownership, in fact BA owned 5% of the stock, and Brother and Sister owned the rest in roughly equal amounts. The buy-sell agreement was funded by term life insurance policies.

The grantor, parent of Brother and Sister, set up an irrevocable trust, Trust 2A, for Brother ("Brother's Irrevocable Trust"). This was a typical flexible generation-skipping trust. Brother was trustee and could make distributions under an ascertainable standard to Brother and Brother's descendants. Brother also had the power to appoint Brother's Irrevocable Trust's assets at Brother's death to anyone except to Brother, Brother's creditors, Brother's estate or the creditors of Brother's estate. The grantor had allocated GST exemption to Brother's Irrevocable Trust, and Brother's Irrevocable Trust was not subject to the rule against perpetuities. Thus, Brother's Irrevocable Trust provides Brother with flexibility to use its assets during life and pass them to practically anyone at death. The grantor also set up Trust 2B for Sister with similar terms ("Sister's Irrevocable Trust").

Under a buy-sell agreement, Brother would buy Sister's and BA's stock at their deaths. Brother owned policies on their lives to fund this purchase. Brother also had the right to assign Brother's purchase rights and obligations to Brother's Irrevocable Trust or other trusts controlled by Brother. Brother would then transfer these policies to the LLC. Brother and Brother's Irrevocable Trust would contribute premiums to the LLC and receive the right to death benefits from Policies on

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[4368] See text accompanying fns. 4110-4112 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 5117, 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).

Sister's and BA's lives in proportion to the premiums that Brother and Brother's Irrevocable Trust made these premium contributions. The goal was to maximize Brother's Irrevocable Trust's proportion of contributions, because Brother's Irrevocable Trust and any trusts created under it are excluded from the estate tax system. However, given the uncertainties of cash flow and the impracticality of frequently changing beneficiary designations, being flexible in sharing premiums was important and the LLC's use of partnership accounting seemed to be the best way to accomplish that. Brother and Sister had virtually identical goals regarding the buy-sell arrangement.

The LLC had some other features. The manager was a corporate trustee. Using a corporate trustee as manager provided security to ensure that no party to the buy-sell agreement would use the life insurance proceeds improperly. The manager was instructed to retain all life insurance proceeds until the parties agreed on their application toward the cross-purchase. Thus, the manager's roles were essentially the equivalent of a combination of trustee of an irrevocable life insurance trust before a shareholder's death and escrow agent for the buy-sell agreement after a shareholder's death.

The LLC's activity required special partnership accounting provisions. Each member had a separate capital account for each policy the member owned on a shareholder. Also, the members needed to contribute cash to pay the LLC's administrative expenses, requiring an additional set of capital accounts.

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

Code § 2042(2) provides that an insured's gross estate includes the value of all property "to the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person."[4369]

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

[4369] 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.

> (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:[4370]

> For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. See subparagraph (6) of this paragraph for rules relating to the circumstances under which incidents of ownership held by a corporation are attributable to a decedent through his stock ownership.

Simple cross-purchase agreements avoid these issues. Rev. Rul. 56-397 ruled that when each of two business associates owns, is the beneficiary of and pays all premiums for an insurance

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[4370] Reg. 20.2042-1(c)(2) elaborates:

> The term "incidents of ownership" also includes a reversionary interest in the policy or its proceeds, whether arising by the express terms of the policy or other instrument or by operation of law, but only if the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy. As used in this subparagraph, the term "reversionary interest" includes a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him. In order to determine whether or not the value of a reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy, the principles contained in paragraph (c)(3) and (4) of § 20.2037-1, insofar as applicable, shall be followed under this subparagraph. In that connection, there must be specifically taken into consideration any incidents of ownership held by others immediately before the decedent's death which would affect the value of the reversionary interest. For example, the decedent would not be considered to have a reversionary interest in the policy of a value in excess of 5 percent if the power to obtain the cash surrender value existed in some other person immediately before the decedent's death and was exercisable by such other person alone and in all events. The terms "reversionary interest" and "incidents of ownership" do not include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or a similar right.

policy on the other business associate, neither of the business associates possesses incidents of ownership in the policy on his or her respective life.

II.Q.4.i.ii.(a). Trust Ownership of Policy

Reg. § 20.2042-1(c)(4) provides:

> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (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.

Below are authorities when the insured is a trustee or a beneficiary.

Does being the trustee of a trust containing an insurance policy on the trustee's life, with the trustee having no beneficial interest in the trust, results in estate tax inclusion under Code § 2042? *Skifter*, 468 F.2d 699 (2nd Cir. 1972) held that the insured as trustee would not have an includable incident of ownership unless the insured had transferred the policy to the trust, implying this requirement into the regulation, which otherwise would not have complied with the statute. GCM 39317 followed this case. However, *Rose v. U.S.*, 511 F.2d 259 (5th Cir. 1975) held that there was no transfer requirement.

Rev. Rul. 84-179 reasoned:

> The legislative history of section 2042 indicates that Congress intended section 2042 to parallel the statutory scheme governing those powers that would cause other types of 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 can not 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)[4371] and 20.2042-1(c)(4) and Rev. Rul. 84-179 and reasoned and held:

[4371] Reg. § 20.2042-1(c)(2) is reproduced in fn 4370 and the text accompanying it in part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

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 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 can not 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 tube 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.[4372]

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

[4372] 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.

> change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The IRS looked to Rev. Rul. 77-182 (no Code § 2036 inclusion where decedent could appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process) and Rev. Rul. 95-58 (no Code § 2036 inclusion where decedent could remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent).[4373]

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.[4374]

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 descendant's 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

[4373] "Related or subordinate" looked to Code § 672(c) – see fn. 2449 in part II.J.3.h Drafting for Flexibility in Trust Income Taxation.

[4374] *Estate of Rockwell v. Commissioner*, 779 F.2d 931 (3rd Cir. 1985).

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.

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 descendant's 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 descendant's.

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 descendant's.

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 effect 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).[4375] This conclusion was based on the view that dividends represent a return of

[4375] CCA 201328030.

premiums[4376] 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 trusts created hereunder and shall have the power to remove or replace any Co-Trustee or sole Trustee

[4376] 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).

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.[4377]

II.Q.4.i.ii.(b). Corporate Ownership of Policy

However, redemptions require further analysis, as do arrangements for cross-purchase agreements when all of the parties hold policies on each other through an entity. If a decedent is the sole or controlling shareholder of a corporation that owns an insurance policy on the decedent's life, then the decedent will not be deemed to possess incidents of ownership as a result of the decedent's stock ownership so long as the proceeds of the policy are payable to the corporation.

II.Q.4.i.ii.(c). Partnership Ownership of Policy

Neither Code § 2042 nor its Regulations specifically address the issues raised by insurance owned by a partnership in which the insured is a partner. However, case law and IRS rulings have analyzed these issues. The Tax Court has held that a general partner does not possess incidents of ownership in a policy that names a general partnership as the owner and beneficiary if the policy was purchased in the partnership's ordinary course of business and the insured partner owned less than a 50% interest in the general partnership.[4378] Rev. Rul. 83-147 held that a partner does possess incidents of ownership if the policy on the partner's life is owned by the partnership, designates a member of the partner's family as the beneficiary, and premiums were paid by the partnership in partial satisfaction of the partner's share of partnership income. The ruling stated that the result was different than the Tax Court case because the beneficiary was not the partnership.

In a number of Letter Rulings, the IRS has addressed Code § 2042 with respect to a partnership that owns and is designated as the beneficiary of an insurance policy on the life of one of its partners.

Letter Ruling 9623024 held that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement states that the proceeds, once received by the partnership, can be distributed to the remaining partners in proportion to their interests to the extent that the proceeds from the policy were not needed to pay the partnership's obligations. The IRS reasoned that the value of the deceased partner's interest would include his pro rata

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[4377] See text accompanying fns 2915-2916 in part II.J.19.h Comparing Annuity to Life Insurance.

[4378] *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).

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."[4379]

In Letter Ruling 200214028, the IRS ruled that the insured general partner did not possess incidents of ownership because the proceeds were payable to or for the benefit of the partnership. In that case, the partnership agreement required that the proceeds be used to redeem the insured partner's interest in the partnership.

TAM 200432015 dealt with Code section 2042 and the transfer of insurance policies to a limited liability company. The TAM deals with Code §§ 2035 and 2042 and involves an insured who transferred an insurance policy on his own life to a limited liability company. If none of the insureds own policies on their own lives that they transfer to a limited liability company, the TAM would not apply.

II.Q.4.i.iii. IRS' Response to Request that Resulted in Letter Ruling 200747002

In response to my ruling request, Letter Ruling 200747002 held that none of the insureds possessed incidents of ownership on the policies that the others contributed to the LLC.

However, the IRS requested some modifications to the LLC's operating agreement. The IRS limited the members' ability to make decisions regarding the LLC's holding of policies. Not mentioned in the ruling is that the operating agreement originally allowed the members voting rights customarily given in a manager-managed LLC, limiting them only to the extent that no member could vote regarding insurance on that member's life. The IRS was concerned that the members could collude in a manner akin to the reciprocal trust doctrine, so it required that the operating agreement preclude members from voting on anything relating to any life insurance policy. Similarly, the IRS required that the operating agreement not expressly authorize amendments by the members, preferring that applicable state law defaults control the situation.

[4379] 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.

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.[4380] Formation of the LLC should not implicate these rules, because formation is a nontaxable transfer.[4381] Similarly, a Member receiving an increased ownership percentage of a policy due to an increased contribution is also a nontaxable transfer.[4382] 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.[4383]

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.[4384] Although the term portion eventually becomes uneconomic, one could use a variety of estate-planning techniques with the cash value portion before that happens so that, ultimately, the insurance arrangement becomes sustainable.

The ruling also held that Brother's Irrevocable Trust was a grantor trust, in which Brother was treated as owning Brother's Irrevocable Trust's assets for income tax purposes under Code § 678; Sister was similarly treated as the owner of Sister's Irrevocable Trust. This was critically important to allow Brother's Irrevocable Trust and Sister's Irrevocable Trust to own stock in the S corporation. Brother initially had a withdrawal right in Brother's Irrevocable Trust that had since lapsed; the same tool was used for Sister and Sister's Irrevocable Trust. Although such withdrawal rights are usually used to obtain the gift tax annual exclusion, in this case a significant purpose of granting withdrawal rights was to obtain grantor trust status treating the beneficiary as the owner.

The above issues are as far as was the ruling was sought to cover. However, this structure has uses far beyond the issues discussed in the ruling.

[4380] Code § 101(a)(2).
[4381] Code §§ 101(a)(2)(A), 721(a).
[4382] Code § 721(a).
[4383] Code § 101(a)(2)(B).
[4384] See footnote 4075 for a summary of how split-dollar arrangements work.

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.[4385] For example, Brother could sell S stock to Brother's Irrevocable Trust in exchange for a promissory note. No income tax would result during Brother's life, because Brother is treated for income tax purposes as owning Brother's Irrevocable Trust. If the IRS determined that the stock's value was too high and that therefore Brother made a gift, Brother would pay no gift tax because the gift is an incomplete gift due to Brother's power to appoint the trust's assets at death. If Brother's Irrevocable Trust were thinly funded, Brother and other trusts created by Grantor for Brother could guarantee the promissory note to provide additional economic reality to the sale.

If Brother dies during the term of the note, Sister and BA would use the insurance to buy Brother's Irrevocable Trust's stock, thus providing cash to retire the note to Brother.

If the sale of S stock to Brother's Irrevocable Trust generates cash flow in excess of the note payments, the excess cash could be used to pay premiums through the insurance LLC, allowing Brother's Irrevocable Trust to participate more in the buy-sell than it would have been able to do with just the net rental proceeds.

Note that Brother has access to the excess funds for Brother's support. The excess funds could also be used to help Brother's children when they are no longer legally dependents, without being limited by the annual gift tax exclusion or using Child 2A's applicable exclusion amount.

What if the parties had used a cash value policy subject to a split-dollar arrangement instead of term policies? After Brother's Irrevocable Trust fully repays the note on the sale of stock, it should have plenty of cash flow to repay the split-dollar obligations.

Sister would use the same strategy.

II.Q.4.i.v. Practical Logistics for Life Insurance LLC

First, keep in mind that any person who is at least a 5% owner of the LLC would be considered an employee whose notice and consent are required, as described in part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance. Whether the parties transfer the life insurance to the LLC or the LLC buys original issue insurance, the parties will probably use a notice and consent along the lines of part II.Q.4.g.iii Consent for Owner Who Is Not an Employee. However, the operating agreement might also include notice and consent as a safety valve.[4386]

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.

[4385] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.
[4386] See fn. fn. 4334, which is found in part II.Q.4.g.i Analysis of Code § 101(j); for an example, see part II.Q.4.g.ii Consent Integrated into Operating Agreement.

If the operating business is 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 rules.[4387]

When the operating company is taxed as a partnership, it might consider setting up a separate distribution account for premiums paid on behalf of each owner. That way, the distributions can be reconciled more easily against what the life insurance LLC is doing.

When the operating company pays a term premium, the life insurance LLC would credit the relevant owner's capital account with a contribution and debit premium expense, with the premium expense separately allocated to the relevant owner.

II.Q.4.i.vi. Letter Ruling 200947006

The IRS has also ruled that an insured who was a partner in a partnership had no incidents of ownership. In Letter Ruling 200947006, the insured had direct and indirect ownership of a partnership that held a policy on his life.[4388] That partnership and other partnerships (in which the insured had direct or indirect ownership) were beneficiaries. The arrangement was restructured so that the insured had no right to make decisions on behalf of a trust that owned the partnership, and the insured's other direct or indirect interest in the partnership was terminated. The IRS ruled that the insured not only had no incidents of ownership after the transaction but also (to avoid Code § 2035) had no incidents of ownership before the transaction.

II.Q.4.i.vii. Conclusion

The Insurance LLC provides security for the owners, facilitates flexibility in making premium payments, and demonstrates a model for reducing the number of policies that must be used in a cross-purchase. Convincing the business owners' parents to set up generation-skipping perpetual trusts to buy real estate used in the business can help the business owners continue to enjoy the business' financial success while moving the business outside of the estate tax system.

For income tax issues generally, see parts II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies. If a life insurance policy owned on a surviving owner receives a new basis when the beneficial owner predeceases the surviving owner,[4389] consider whether this new basis increases the "investment in the contract" and, if not, whether additional steps should be taken to effectuate that increase.[4390]

[4387] See part II.A.2.i.ii Temporary Timing Differences.

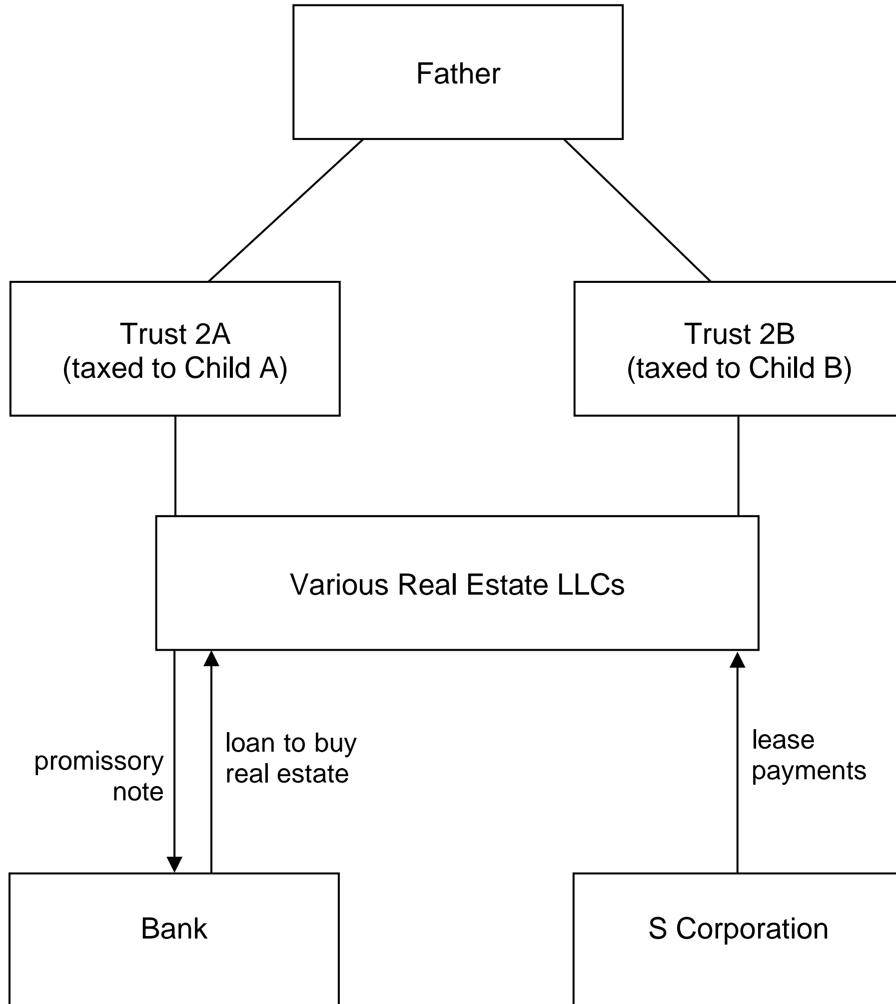
[4388] See also Letter Rulings 200948001 and 200949004, which appear to be companion rulings.

[4389] 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.

[4390] See part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured.

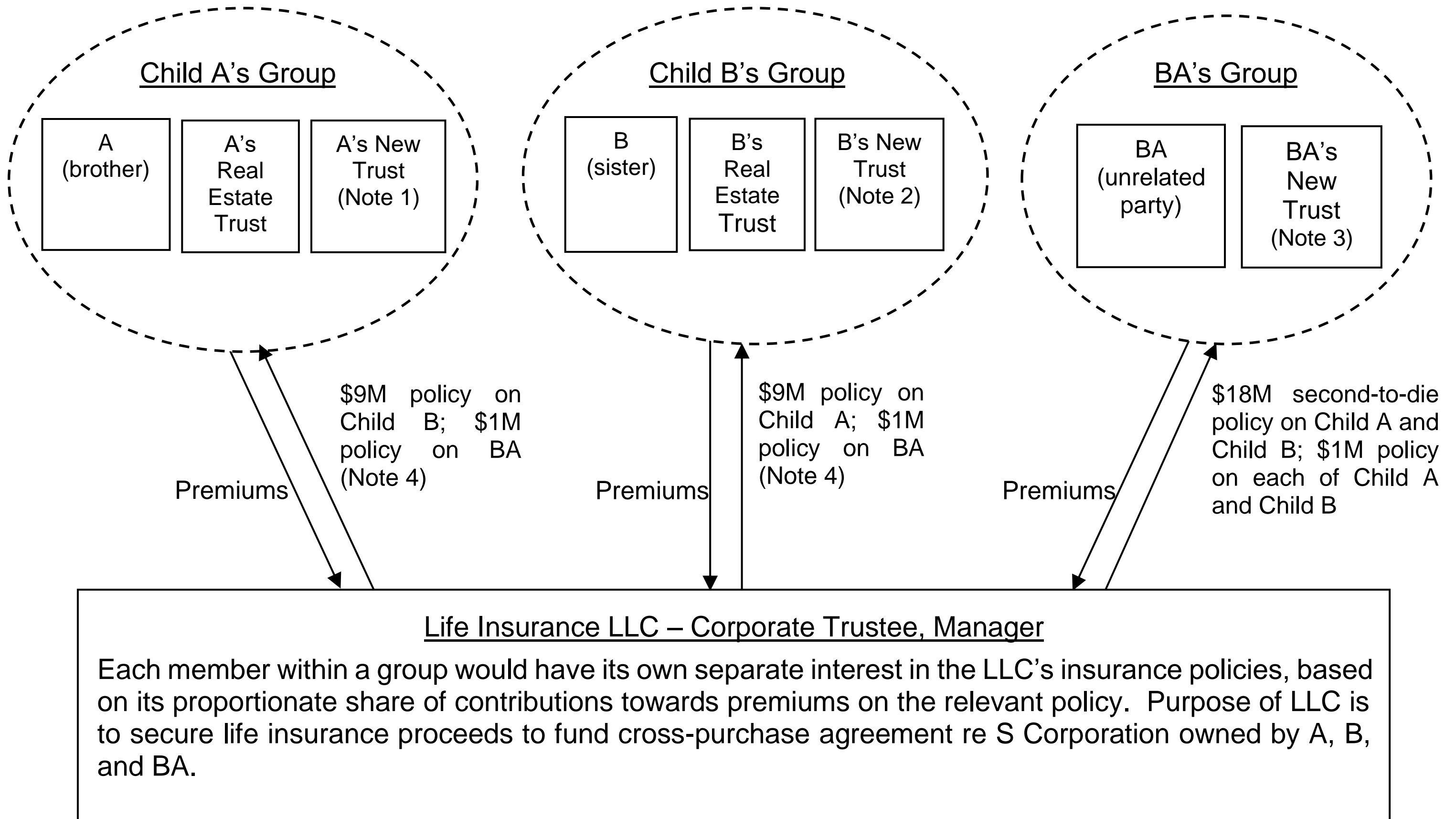
Appendix A

Prior Formation of Trusts



Appendix B

Insurance LLC Structure



Note 1: Child A would be the grantor and trustee of this irrevocable trust for his spouse's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

Note 2: Child B would be the grantor and trustee of this irrevocable trust for her descendants' support. (Her children are adults.) Her grandchild would be cut out, but her son could include him.

Note 3: BA would be the grantor and trustee of this irrevocable trust for his wife's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

Note 4: If Child A dies first, Child B's group would become the premium payer with respect to Child A's group's policy on BA's life. If Child B dies first, Child A's group would become the premium payer with respect to Child B's group's policy on BA's life.

Appendix C

Later Sale of S corporation Stock to Irrevocable Grantor Trust