

**Life Insurance to Fund Buyouts or Loss of a Key Person  
Practical Ways to Avoid Tax Traps and Other Pitfalls**

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

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by Steven B. Gorin \*

These materials are excerpted from “Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications” over 1,000 pages of material available in a PDF.

*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 the PDF or this newsletter, please email the author at [sgorin@thompsoncoburn.com](mailto:sgorin@thompsoncoburn.com) with “Gorin’s Business Succession Solutions” in the subject line and indicate whether you want the PDF, newsletter, or both; 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](mailto: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](mailto:sgorin@thompsoncoburn.com) and not to [ThompsonCoburnNews@tcinstitute.com](mailto:ThompsonCoburnNews@tcinstitute.com), which is not the author’s email address but rather is an address used to transmit newsletters.*

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## **II.O. Buy-Sell Agreements**

### **II.O.1. General Buy-Sell Concepts**

A buy sell agreement is a contract between owners and/or the entity that provides for the sale of an owner's interest upon the occurrence of a triggering event such as disability, retirement, or death. The three types of buy-sell agreements are: (1) redemption agreements; (2) cross-purchase agreements; and (3) a combination of redemption and cross-purchase. Deciding which type to use requires consideration of a number of factors including the number and ages of the shareholders involved and the weighing of tax consequences for each type of agreement.

These agreements determine the price and payment terms and restrict who can own an interest in the business. In a limited liability company (LLC), the buy-sell agreement is integrated into the operating agreement. In a partnership, the buy-sell agreement is integrated into the partnership agreement. In a corporation, whether a C corporation or an S corporation, the buy-sell agreement is integrated into a shareholders' agreement.

Key circumstances triggering a buy-sell agreement include the owner's divorce, bankruptcy, incapacity, or death. Special considerations may apply to an owner who works in the business, especially if the ownership interest was granted as an employment incentive. Also, owners like to choose their partners, so frequently the buy-sell provisions restrict transfers to outsiders.

In LLCs and partnerships, voting and management rights are not transferred automatically when ownership is transferred. An owner without voting and management rights is called an assignee. LLC and partnership buy-sell provisions specify whether a transferee is an assignee or has voting and management rights.<sup>1956</sup>

An S corporation may revert to a C corporation if too many shareholders own stock or if stock is transferred to an ineligible shareholder. Special buy-sell provisions are required to preserve the S election.

The Business Planning Committee of the American College of Trust & Estate Counsel has put together a model shareholder agreement and related outline of technical issues. These two documents can be found at the web page of the Business Planning Group of the American Bar Association's Real Property, Trust & Estate Law Section at <http://apps.americanbar.org/dch/committee.cfm?com=RP519000>.

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<sup>1956</sup> A Delaware Court of Chancery held that an assignee's admission as a member must be done formally and that an assignee who is not a creditor could assert rights in equity without being admitted as a member. *In re Carlisle Etcetera LLC*, C.A. No. 10280-VCL (4/30/2015), found at <https://casetext.com/case/in-re-carlisle-etcetera-llc>.

## **II.O.2. Spousal Issues in Buy-Sell Agreements and Related Tax Implications**

Generally speaking, it is usually best to have a spouse hold a business interest through a trust, rather than through outright ownership. The trust can protect the property from creditors and from new spouses if the surviving spouse remarries. A trust also allows the decedent to choose to have a third party involved in the management and investment of the property, if desirable. Additionally, a trust allows the decedent to designate who the remainder interest in the property passes to upon the spouse's death and might enable the decedent to devise property to successive generations without incurring estate tax. Finally, the trust form will allow the donor to structure the estate plan to take advantage of any potential minority discounts or control premiums that may apply.

### **II.O.2.a. Spouses and Buy-Sell Agreements – State Law Issues**

A number of issues can arise related to spouses holding interests in closely-held businesses. If these issues are not addressed, closely-held business owners could end up in losing a portion of their business to an ex-spouse, or an owner's estate could lose part or all of the marital deduction.

Some courts have held a business owner's buy-sell agreement not binding on the spouse, so spousal consent should be considered necessary to ensure enforcement of buy-sell agreements. First, such consent can prevent a divorce proceeding or elective share from causing an ex-spouse to be involved in the business. It also prevents a spouse from leaving her community property interest in the business to a third party. Finally, it protects the spouse from claiming a community property interest in the business upon the business owner's death.

However, even if the spouse consents by signing the buy-sell agreement, a court might rule that the spouse did not truly consent to the agreement because the spouse did not fully understand the agreement.<sup>1957</sup> Preferably, the spouse would be represented by his or her own counsel. Be sure to update spousal consent when amending the buy-sell agreement.

### **II.O.2.b. Divorce – Income Tax Issues Relating to Buy-Sell Agreements**

In order to accomplish its objectives, a buy-sell agreement needs to specifically address transfers incident to divorce. If an agreement focuses on voluntary transfers, it is possible a court would not apply the restriction in the case of an involuntary transfer, such as a divorce transfer.

When a business interest is transferred to a spouse pursuant to a divorce agreement and the stock is then redeemed by the business for cash pursuant to the buy-sell agreement, the non-recognition rules for spousal transfers and the stock redemption rules collide. Before tax regulations addressed this situation, there was some question as to whether the transferring spouse should be taxed on the redemption or the spouse receiving the interest

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<sup>1957</sup> See, e.g. *Suther v. Suther*, 627 P.2d 110 (Wash. App. 1981).

should be taxed. Reg. § 1.1041-2(c) addresses this question and states that the spouses may choose who will be taxed on the redemption.<sup>1958</sup>

### **II.O.2.c. Effect of Buy-Sell Agreement on Marital Deduction**

The buy-sell agreement price can have a significant effect on the estate tax marital deduction. If stock held in a marital trust is subject to a bargain buy-sell agreement, the marital deduction might be totally disallowed.<sup>1959</sup> Such a provision might run afoul of Code § 2056(b)(5), which allows a marital deduction only if no other person has the power to appoint any portion of the interest to anyone except the surviving spouse, and Code § 2056(b)(7), which requires that the spouse be the only beneficiary. Consider the following:

- Provide that, if the property passes to a marital deduction trust, the agreement provide that the sale price shall be adjusted up as necessary to be no less than the fair market value, as finally determined for estate tax purposes.
- Bequeath the business interest to a marital deduction that is separate from other marital deduction trust assets, so that the marital deduction for those other assets is not jeopardized.

On the other hand, FSA 200018020<sup>1960</sup> stated that directing stock to be sold for a bargain price before funding the QTIP Trust did not disqualify the QTIP trust; it simply affected the amount available for the marital deduction. The FSA distinguished the *Rinaldi* case

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<sup>1958</sup> In another setting indirectly involving a transfer of a business interest, Letter Ruling 201024005 held that the transfer of qualified replacement property (“QRP”) to a divorcing spouse is not subject to income tax. Under Code § 1042, QRP is certain stock purchased with the proceeds of a sale of stock to an employee stock ownership plan (ESOP); this purchase allows the seller to defer gain on the sale, which deferred gain reduces the QRP’s basis. Code § 1042(e) requires the deferred gain to be recognized if the seller later disposes of the QRP. Code § 1042(e)(3)(C) provides that a gift does not count as a Code § 1042(e) disposition. Code § 1041(b)(1) and its legislative history provide that a transfer in a divorce counts as a gift for income tax purposes, so the ruling held that a transfer of QRP by divorce was not subject to Code § 1042(e) recapture.

<sup>1959</sup> See *Estate of Rinaldi v. U.S.*, 38 Fed. Cl. 341 (1997); *Estate of McCabe v. U.S.*, 475 F.2d 1142 (Ct. Cl. 1973); TAM 9147065. See also TAM 8843004. The IRS took a similar position (without citing these cases) and lost in *Alan Baer Revocable Trust v. U.S.*, 105 A.F.T.R.2d 2010-1544 (D.C. Neb.), when the court disregarded a contingent distribution to beneficiaries because the “possibility that the transfer to the contingent beneficiaries would ever come to fruition is so remote that it is negligible.” The IRS acquiesced in result only in AOD 2012-001, arguing that any possibility whatsoever of others receiving the trust’s possibility violated the Code § 2056(b)(7)(B)(ii)(II) prohibition against any person having “the power to appoint any part of the property to any person other than the surviving spouse.” The IRS claimed that Reg. § 20.2056(b)-7(d)(6) supports its position. That regulation provides that, “if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money’s worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied.” Although generally I would want to avoid arguing with the IRS over this issue in a buy-sell agreement, perhaps the formula used in *Wandry* (see text accompanying note 3851) might work if one can find no other way to plan around this issue?

<sup>1960</sup> FSA 200018020 was approved by Melissa Liquerman, who has had a long and successful career with the IRS and I believe is very well-regarded.

cited in fn. 1959. If a bargain sale before funding the marital trust is not directed by the estate plan but rather is done as part of estate administration, then the marital deduction should be allowed in full and the surviving spouse is treated as making a gift.<sup>1961</sup>

A right of first refusal to buy at fair market value stock that a QTIP Trust sells upon the surviving spouse's demand did not disqualify a QTIP trust.<sup>1962</sup> A thirty day period in which to exercise a right of first refusal is not an unreasonable burden on a spouse's right to make a QTIP trust productive.<sup>1963</sup>

Here is an example of another business interest that qualified:<sup>1964</sup>

The surrounding circumstances also manifest Taxpayer's intention that, after his death, Marital Trust should produce for Spouse during her life that degree of beneficial enjoyment of the LLC Preferred Units which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Under the terms of Operating Agreement, as the owner of LLC Preferred Units, Marital Trust will be entitled to an eight percent return on the aggregate face value of its LLC Preferred Units, payable no less often than annually. LLC cannot redeem Marital Trust's LLC Preferred Units for less than the greater of their face value or fair market value. In addition, without the affirmative vote or consent of all of the Preferred Members, LLC's Voting Common Members cannot amend, restate, alter or repeal Operating Agreement whether by merger, consolidation or otherwise so as to directly materially and adversely affect any right or preference of the Preferred Units or Preferred Unit holders.

Moreover, the sale of LLC Preferred Units is not unreasonably restricted. At the written request of Spouse, the trustee of Marital Trust may sell the LLC Preferred Units to permitted purchasers without the consent of other LLC Members. Subject only to reasonable administrative restrictions, these purchasers will become substitute Preferred Members. The permitted purchases are other Members of LLC, Taxpayer's children, and Qualified Institutional Investors (as

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<sup>1961</sup> See Rev. Rul. 84-105, which is described in fn. 3594, which is found in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers.

<sup>1962</sup> Letter Ruling 199951029 held:

If Spouse requests the trustee to convert the stock into income producing property, Grantor's children have the right of first refusal to purchase the stock at its fair market value as determined by an independent appraisal and under such terms and conditions as would be agreed upon by parties dealing at arm's length. This restriction does not prevent the trust from receiving full value for the stock if the stock is sold to the children, nor does it restrict the trustees' ability to sell the stock.

<sup>1963</sup> Letter Ruling 8931005 held:

Given the fact that Corporation is a closely-held entity and the Children's Trust (owner of the controlling interest) is one of the most likely purchasers of the minority interest held by the Marital Trust, we do not consider the thirty day right of first refusal to place an undue burden on the ability of Spouse to require that the trust corpus be made productive.

<sup>1964</sup> Letter Ruling 201410011.



defined by Operating Agreement). Taxpayer has demonstrated that a substantial number of Qualified Institutional Investors currently own interests in B and that they are common purchasers of REITs. With respect to the actual receipt of income from an investment in B, an indirect owner of interests in B who owns LLC Preferred Units is in a similar position as a direct owner of interests in B because LLC is required to distribute an eight percent preferred return annually to owners of LLC Preferred Units.

#### **II.O.2.d. Marital Trusts - S Corporations**

When a business passes to a surviving spouse in a trust, a QSST or an ESBT election must be made.

Testamentary QTIP trusts generally qualify as QSSTs, and QSSTs often have more favorable income tax effects than ESBTs.

See parts III.A.3.c.iii Deadlines for QSST and ESBT Elections and III.A.3.e QSSTs and ESBTs (including part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies).

#### **II.O.2.e. Marital Deduction Trusts - Discount Planning**

Much of the discussion below assumes that valuation reduction is good. That is not necessarily the case; see part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property), including part II.H.3 Valuation Discounts – Friend or Enemy. Accordingly, consider whether to plan to avoid valuation discounts, as needed.

Minority and fractional discounts for closely-held businesses and marital trusts need to be considered in estate planning as well. When spouses together own a majority in a business under community property laws, they will be considered to own one-half of that interest, and thus will be entitled to discounts for lack of control in determining their estate value.<sup>1965</sup> Additionally, fractional interest discounts may come into play when property interests are divided between a QTIP trust and a spouse. For example, if the surviving spouse owns 60% of a business and the remaining 40% is held in a QTIP trust, one might assume discounts for lack of control will not come into play when the second spouse dies. However, courts have held that the spouse's estate will be entitled to a discount for lack of control by disaggregating the QTIP trust from the spouse's other assets (in this example, providing a discount for lack of control for the QTIP stock).<sup>1966</sup> However, this disaggregation would not apply to a general power of appointment marital trust (Code § 2056(b)(5)).<sup>1967</sup>

Another issue arises when a business owner has a controlling interest in the company and bequeaths some portion of that interest to his spouse. Upon the owner's death, the full

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<sup>1965</sup> See *Estate of Bright v. U.S.*, 658 F.2d 999 (5<sup>th</sup> Cir. 1981).

<sup>1966</sup> See *Estate of Bonner v. U.S.*, 84 F.3d 196 (5<sup>th</sup> Cir. 1996); *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999); *Nowell v. Commissioner*, T.C. Memo. 1999-15.

<sup>1967</sup> *Estate of Fontana v. Commissioner*, 118 T.C. 318, 322 (2002).

controlling interest value must be included in determining the owner's gross estate, and the estate will be entitled to some marital deduction for the portion passing to the spouse. However, that deduction is based on what passes to the spouse, not what is included in the estate. In *Estate of Chenoweth v. Commissioner*,<sup>1968</sup> the decedent owned 100% of a business and left his spouse a 51% interest. The IRS claimed the highest marital deduction the estate could take was 51% of the full value of the business included in the gross estate, but the estate claimed it should be entitled to increase the deduction by some control premium. The court ruled that the estate should be entitled to attempt to prove the increased value and that no rule required that the marital deduction amount equal the value the property was assigned when included in the gross estate. While this holding can lead to a potential tax advantage for an estate, it also has a potentially negative effect. What if the decedent owned a controlling interest but passed a minority interest to the spouse? In this case, the marital deduction will be based on the value of the minority interest, even though the full value of the interest will be used in calculating the gross estate.<sup>1969</sup> This same result can occur in the charitable contribution deduction context, when a decedent leaves a minority interest in stock to a charity.<sup>1970</sup> Thus, estate planners need to be aware of this whipsaw effect when determining how the estate will be divided.<sup>1971</sup> For example, if a controlling interest is to be divided among charities, with

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<sup>1968</sup> 88 T.C. 1577 (1987).

<sup>1969</sup> TAM 9403005. In *Estate of Frank M. DiSanto v. Commissioner*, T.C. Memo 1999-421, the decedent had a controlling interest and a non-controlling interest passed to the surviving spouse, creating a mismatch between inclusion and deduction.

<sup>1970</sup> See generally *Estate of Schwan v. Commissioner*, T.C. Memo 2001-174 (taking into account post-mortem transformations occurring in funding a charitable bequest).

<sup>1971</sup> Steve Akers of Bessemer Trust has a post-mortem outline that, as of 2/8/2014, included the following as possible solutions:

- \* Have the executor to fund the marital bequest with a note. The residuary estate would then be burdened with the note as a liability that would be distributed along with the residuary assets to the residuary beneficiaries.

A strategy that may have worked previously: Have someone purchase a minority interest from the estate within the first six months, and elect the alternate valuation date. If the remaining interest is a minority interest, the alternate valuation date values would reflect minority interest values in the estate. Alternatively, consider merely distributing minority block of stock, and value the block distributed (minority interest) and the remaining block of stock in the estate at the end of the six month period (which might also be a minority interest). See Treas. Reg. § 20.2032-1(c)(1)(phrase "distributed, sold, exchanged or otherwise disposed of" includes surrender of stock in complete or partial liquidation of a corporation but not "mere changes in form" such as a transfer of assets to a corporation in a manner that no gain or loss is recognizable under § 351); *Kohler v. Comm'r*, T.C. Memo 2006-152, nonacq. AOD 2008-001 (tax-free reorganization is not a disposition that accelerates alternate valuation date). Proposed regulations prohibit this strategy, with an effective date of when the regulation is finalized. Prop. Treas. Reg. § 20.2032-1(h).

- \* For fractional interests in real estate, use a co-ownership agreement at the first spouse's death that will eliminate the discount, by providing that either co-tenant can sell the property and distribute the proceeds pro rata.

- \* For stock, use a pro rata funding but have a shareholder agreement that will eliminate the discount (by giving the marital legatee the right to liquidate the company or otherwise have control).

- \* Sell the majority interest to a Family Trust for a note, then fund the Marital Trust with a part of the note, and fund the Family Trust with the balance of the note (which the Family Trust would then owe to itself).

each receiving a minority interest, the IRS might argue that the bequest to each receives a minority discount; instead, consider (a) bequeathing the controlling interest to a private foundation for the benefit of those charities, or (b) including a direction to sell the business interest and distribute the proceeds, perhaps giving the charities an option to take in kind.

### **II.O.3. Effect of Buy-Sell on Charitable Estate Tax Deduction**

If a decedent owns voting and nonvoting shares, the shares are valued together as a single block; however, if the charitable bequest is a specific bequest of stock that is less than the combined block, the charitable deduction is based on the block it actually received.<sup>1972</sup>

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\* Distribute a majority interest in an asset (that exceeds the marital bequest amount) to the Marital Trust, and have the Marital Trust give the estate back a note for the excess value. (For example, assume there is a \$2MM Family Trust and a \$8MM Marital Trust and the only asset is a 51% interest in a closely held company that is worth \$10MM. If the Marital Trust is funded with 8/10 of the 51% interest, it will not be worth \$8MM. Fund the Marital Trust with the entire 51% controlling interest, and have the Marital Trust give a note back to the estate for \$2MM. The Marital Trust might later end up paying off the \$2MM note with an interest in the company (which would be valued at a discount, thus requiring more shares than if there were no discount).

\* Fund the bequest using a “defined value” formula conveyance. For example, a pecuniary bypass trust bequest could be funded by a conveyance having a defined value—reduced only by the amount necessary that will not result in an increased estate tax.

\* To avoid the valuation problem on funding marital bequests, make the marital gifts during lifetime. In that event, there would not be a mismatch between the amount of the gift and the allowed marital deduction. (But lifetime gifts would lose the benefit of a basis step-up at death.)

<sup>1972</sup> *Ahmanson Foundation v. United States*, 674 F.2d 761 (9<sup>th</sup> Cir. 1981). In that case, the sole share of voting stock was specifically bequeathed to a noncharitable beneficiary, and ninety-nine shares of nonvoting stock were specifically bequeathed to charity. The court reasoned:

The Foundation argues that it makes no difference if we conclude, as we did in section II, that the gross estate should include the value of the 600 HFA shares in the hands of Ahmanson, because the 99 nonvoting shares must have the same value for the charitable deduction as they have in the gross estate. The Foundation argues that inconsistent valuations, for these two purposes, would be incompatible with the orderly administration and application of the estate tax law. There is, certainly, an initial plausibility to the suggestion that fairness dictates that the same method of valuation be used in computing the gross estate and the charitable deduction. This initial plausibility, however, does not survive a close second look.

The statute does not ordain equal valuation as between an item in the gross estate and the same item under the charitable deduction. Instead, it states that the value of the charitable deduction “shall not exceed the value of the transferred property required to be included in the gross estate.” 26 U.S.C. §2055(d). Moreover, the statutory scheme specifically requires a lower valuation for the charitable deduction than for the same item within the gross estate under certain circumstances. If the alternate valuation date is used and the property becomes more valuable by virtue of a contingency occurring between the date of death and the alternate valuation date, the higher value is included in the gross estate, but the lower value is used in computing the charitable deduction. 26 U.S.C. § 2032(b).

In light of the purpose of the charitable deduction to encourage gifts to charity, it seems doubtful that Congress intended to give as great a charitable deduction when the testamentary plan diminishes the value of the charitable property as it would when the testamentary plan conveys the full value of the property to the charity intact. That is, the intent of encouraging charitable gifts suggests the further policy of encouraging greater rather than lesser charitable gifts. By severing the voting power of the stock from its economic entitlement, and giving only the economic

Furthermore, when the trustee caused controlling stock bequeathed to charity to be redeemed for a value based on discounts for lack of control, the charitable deduction was correspondingly reduced, and the estate was assessed penalties.<sup>1973</sup>

#### **II.O.4. Effect of Buy-Sell on Reasonable Compensation Arguments**

In recharacterizing deductible compensation as nondeductible dividends, the Tax Court in 2016 held that an independent investor<sup>1974</sup> would have demanded a return on investment as a shareholder.<sup>1975</sup>

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entitlement to charity, Ahmanson reduced the value of the stock to the charity. In the present case, the district judge found that the reduction in value was relatively small. Under other circumstances, however, the reduction in value might be substantial. The proper administration of the charitable deduction cannot ignore such differences in the value actually received by the charity.

Thus there are compelling considerations in conflict with the initially plausible suggestion that valuation for purposes of the gross estate must always be the same as valuation for purposes of the charitable deduction. When the valuation would be different depending on whether an asset is held in conjunction with other assets, the gross estate must be computed considering the assets in the estate as a block. Otherwise, as discussed above, the testator would be able to produce an artificially low valuation by manipulatively disbursing complimentary assets into the hands of different beneficiaries—only to have those beneficiaries recombine the assets in their more valuable arrangements at some later time. The valuation of these same sorts of assets for the purpose of the charitable deduction, however, is subject to the principle that the testator may only be allowed a deduction for estate tax purposes for what is actually received by the charity—a principle required by the purpose of the charitable deduction.

Therefore the district judge erred in concluding that the valuation of the 99 nonvoting shares of Ahmanco stock would be the same for the purpose of the charitable deduction and for purpose of the gross estate. The district judge should recompute the taxable estate, beginning with a value in the gross estate equal to the 100 shares of Ahmanco undiminished by the 3 percent reduction for the nonvoting status of the 99 shares. The charitable deduction should then be computed on the basis of that 3 percent decrease in value that resulted from the severance of the voting rights from these 99 shares.

<sup>1973</sup> *Estate of Dieringer v. Commissioner*, 146 T.C. No. 8 (2016), reasoning:

We do not believe that Congress intended to allow as great a charitable contribution deduction where persons divert a decedent's charitable contribution, ultimately reducing the value of property transferred to a charitable organization. This conclusion comports with the principle that if a trustee "is empowered to divert the property ... to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed ... the deduction will be limited to that portion, if any, of the property, or fund which is exempt from an exercise of the power." Sec. 20.2055-2(b)(1), Estate Tax Regs. Eugene and his brothers thwarted decedent's testamentary plan by altering the date-of-death value of decedent's intended donation through the redemption of a majority interest as a minority interest.

The trust did not transfer decedent's bequeathed shares nor the value of the bequeathed shares to the foundation. Accordingly, we hold that the estate is not entitled to the full amount of its claimed charitable contribution deduction.

In sustaining the penalty, the court reasoned:

DPI's lawyer's advice regarding the charitable contribution deduction was based on an errant appraisal. The date-of-death appraisal and the redemption appraisal--performed only seven months apart--differed substantially in value. The estate knew that a significant percentage of the value of decedent's bequeathed shares was not passing to the foundation and that Eugene and his brothers were acquiring a majority interest in DPI at a discount.

In that particular case, the net book value, determined on a cash basis, was sufficient to justify the IRS' conclusion that a particular portion of distributions constituted dividends. Consider, however, that a buy-sell agreement might constitute evidence of a company's value that might support an IRS attack asserting that the corporation's value is higher and that therefore distributions taxable as nondeductible dividends should be higher:

- Generally, a business is worth the present value of its future profits, as they are distributed annually or upon liquidation.<sup>1976</sup>
- Therefore, if a company has no profits, it has no value. Conversely, if a company has value but does not report profits, then presumably either the value is based on expected future profits based on efforts that have not yet generated results or the expenses are overstated.
- Appraisals of controlling interests in business often adjust compensation to what the appraisers believe is reasonable. These appraisals might be dangerous to a C corporation, that does not want its compensation deductions to be denied.

C corporation owners often assert that compensation to zero out income is reasonable, yet the business has value to an investor. The IRS might assert that the latter is an admission of value on which dividends should be paid. An advisor might consider addressing this issue very directly with the client and revisiting choice of entity in light of a possible intellectual inconsistency that might come back to bite the taxpayer in the long run.

A seller-financed buyout is best done using a partnership,<sup>1977</sup> so consider converting to a partnership to avoid these issues,<sup>1978</sup> which does not necessarily mean paying otherwise avoidable self-employment tax.<sup>1979</sup> If converting to a partnership is not acceptable, consider making an S election.<sup>1980</sup>

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<sup>1974</sup> Many cases have looked to the "independent investor" test in determining reasonable compensation. See fn. 35.

<sup>1975</sup> *Brinks Gilson & Lionie A Professional Corporation v. Commissioner*, T.C. Memo. 2016-20.

<sup>1976</sup> See part III.C Fairness Within Families; Valuation.

<sup>1977</sup> See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

<sup>1978</sup> See part II.E.5.c Flowcharts: Migrating Existing Corporation into Preferred Structure.

<sup>1979</sup> See parts II.E.3 Recommended Long-Term Structure – Description and Reasons and II.E.4 Recommended Long-Term Structure - Flowchart. See the paragraph that includes fn. 414 for avoiding self-employment tax and when one might not want to avoid self-employment tax.

<sup>1980</sup> See parts II.A.2.b Existing Corporation - Paying Retired Shareholder-Officers and II.P.3.c Conversions from C Corporations to S corporations.

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

### **II.Q.4.a. Funding the Buy-Sell; Transfer for Value Rules**

Insurance is by far the most common method by which a buy-sell agreement is funded, whichever form of agreement is used. Special rules apply if the beneficiary is two generations (or the equivalent) younger than the insured.<sup>2237</sup> If a business owner has a parent with an estate tax problem, that parent's estate tax problem might lend itself to a special opportunity to pay for the policies that fund the buy-sell.<sup>2238</sup>

Not enough attention is focused on disability insurance, which can protect the business' cash flow due to the interruption caused and might also help fund buyouts. To the extent disability is to benefit the disabled person, one should avoid the draconian Code § 409A rules,<sup>2239</sup> which have a stringent disability provision,<sup>2240</sup> and instead pay the key employee compensation sufficient for that person to buy his or her own disability policy.

Having life insurance proceeds paid directly to the selling shareholder does not make the sale tax-free; rather, the payment is treated just as would be any other payment to a seller<sup>2241</sup> (which might be tax-free if the seller has sufficient basis, for example because of a basis step-up in the business interest).

Funding with life insurance under a cross-purchase plan will require that each shareholder own a life insurance policy on the life of every other shareholder. If there are more than three owners, however, policy ownership can become complicated and a stock redemption agreement may make better sense. One alternative to a stock redemption agreement may be a trustee agreement whereby the trustee would act as custodian of the policies and purchase one life insurance policy for each shareholder. This avoids the need for multiple policies when there are more than two shareholders. If a stock redemption arrangement is employed, the corporation purchases a life insurance policy on each shareholder. Upon the shareholder's death, the beneficiary then uses the proceeds to purchase the decedent's shares. Similarly, as described in a Letter Ruling, the shareholders could form a limited liability company to own life insurance on each other, with the manager of the LLC retaining the proceeds until the parties agree on proper application of the proceeds.<sup>2242</sup> Also note that split-dollar life insurance

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<sup>2237</sup> If the policy proceeds are \$250,000 or more, the life insurance company will need to verify with the beneficiary that the beneficiary is not a "skip person" receiving a payment subject to generation-skipping transfer (GST) tax; otherwise the insurance company might need to file relevant forms reporting and paying GST tax. See the Examples under Reg. § 26.2662-1(c)(2)(vi).

<sup>2238</sup> This tool, generational split-dollar, is described as it was approved in fns. 2341-2343 in part II.Q.4.e.ii.(b) Treatment of Split-Dollar Arrangement under Reg. § 1.61-22.

<sup>2239</sup> See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

<sup>2240</sup> See part III.B.4.c.vi Deferred Compensation, especially fn. 4231.

<sup>2241</sup> For an analogous situation, see Rev. Rul. 70-254, which is based on *Landfield Finance Company v. U.S.*, 418 F. 2d 172 (7<sup>th</sup> Cir. 1969), which in turn is based on Reg. § 1.101-1(b)(4).

<sup>2242</sup> See part II.Q.4.h Life Insurance LLC.

arrangements<sup>2243</sup> are subject to Code § 409A rules restricting the events upon which deferred compensation can be paid, the violation of which trigger significant tax, penalties, and interest.<sup>2244</sup> When drafting a shareholder agreement using life insurance, consider authorizing transfers of the policy to the insured for fair market value to avoid Code § 409A risks; defining the value as cash surrender value might not be sufficient, particularly because features, such as no-lapse guarantees (which is the equivalent of prepaid insurance that is not revealed on annual insurance policy statements), provide additional value that is tracked through the life insurance company's internal "shadow account" that can provide surprising results when the insurance company issues IRS Form 712.<sup>2245</sup> Also, make sure that any rights an insured might have to purchase a policy others hold on his life arise only as a collateral consequence of acts or events of independent significance, so that they do not constitute an incident of ownership.<sup>2246</sup>

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

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<sup>2243</sup> Split-dollar is a cash value life insurance financing arrangement described in Reg. §§ 1.61-22 and 1.7872-15, with cross-references found in Reg. §§ 1.83-6(a)(5) (income tax treatment on rollout of employee split-dollar), 1.301-1(q) (shareholder arrangements), and 1.1402(a)-18 (self-employment tax issues). See part II.Q.4.e Split-Dollar Arrangements.

<sup>2244</sup> Notice 2007-34 sets forth transition rules. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules, for a discussion of Code § 409A, including the permissible triggering events. Events that terminate pre-2005 split-dollar agreements often do not comply with these permissible triggering events, so a review of pre-2005 split-dollar agreements is a good idea. See Zaritsky, Aghdami & Mancini, ¶8.02. Life Insurance Funding, *Structuring Buy-Sell Agreements: Analysis With Forms*.

<sup>2245</sup> For income tax valuation of policies, see fn. 2256. In the case of a split-dollar arrangement entered into on or before September 17, 2003, and which is not materially modified after that date, only the cash surrender value of the contract is considered to be property. Reg. § 1.83-3(e). Reg. §§ 20.2031-8 and 25.2512-6 determine the value for estate and gift tax purposes - based primarily on interpolated terminal reserve as a measure of the replacement value; see fn. 2258 for more information on this authority.

<sup>2246</sup> Letter Ruling 8049002 held that no incidents of ownership existed when a shareholder agreement gave the decedent the option to purchase policies at a price equal to the transfer value (cash surrender value), which option was exercisable only if decedent terminated his shareholder relationship with the corporation by offering all stock to the corporation and/or the other principal. This first-refusal option would become operative when a shareholder receives a bona fide offer, a shareholder terminates employment, or a shareholder becomes totally and permanently incapacitated. At date of death, although the option was still outstanding, the decedent had not terminated his shareholder relationship or acted in any way to exercise his option with respect to the insurance policies. The ruling was based on Rev. Ruls. 72-307, 75-50, and 79-46, from which the IRS gleaned an absence of incidents of ownership because the decedent could not independently initiate the events which would enable him to gain control over the policies (except, perhaps, by terminating employment, and, even then, he would not control the corporation's decision to repurchase). Thus, he lacked not only the practical ability to exercise any power with respect to these policies but also any power over the policies. Letter Ruling 9233006 also found no incidents of ownership when shareholders could buy policies on their respective lives and, thus, prevent cancellation of these policies only if the corporation redeems their stock interests in the event that the insured is disabled for a prescribed period of time, the insured declines to participate in the sale of the corporation to a third party, or the insured declines to participate in a public offering of the corporation's stock. Thus, the right to acquire the insurance policies and thus, prevent cancellation would arise as a collateral consequence of acts or events of independent significance. That ruling also cited Rev. Ruls. 84-130 and 80-255.

In a redemption agreement, the value of the insurance on the decedent's life will not be includable in the decedent's gross estate for federal estate tax purposes if the corporation is the owner and beneficiary of the policy,<sup>2247</sup> and the insurance proceeds received by the corporation will not be subject to income tax.<sup>2248</sup> Unless a valid agreement that satisfies Code § 2703<sup>2249</sup> provides otherwise, the insurance proceeds will, however, be considered in valuing the decedent's interest in the business,<sup>2250</sup> but perhaps offset by the buy-sell obligation.<sup>2251</sup> Insurance premiums used to fund the agreement are not deductible by the corporation.<sup>2252</sup>

A cross-purchase generally would constitute a taxable sale, treated as a capital gain.<sup>2253</sup> In many cases, a cross-purchase or a redemption that is paid over time can qualify for tax deferral as an installment sale.<sup>2254</sup> However, tax deferral on installment sales can be limited,<sup>2255</sup> so do not assume that it is available without our first having the rules thoroughly researched.

In a cross-purchase arrangement, the value of life insurance owned on the decedent's life by a surviving shareholder will not be included in the decedent's estate for federal estate tax purposes, but the decedent's gross estate will include the value of life insurance the decedent owned on the lives of the surviving shareholders. Premiums paid by the shareholders to fund the agreement are not deductible by the shareholders, and the insurance proceeds paid to the surviving shareholders will not be subject to income tax.

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<sup>2247</sup> Rev. Rul. 82-85, relying on Reg. § 20.2042-1(c)(6). If the decedent controls the entity that owns the policy and the insurance proceeds are not payable to the corporation or otherwise used for a valid business purpose (such as in satisfaction of a business debt of the corporation) so that the net worth of the corporation is increased by the amount of such proceeds, then the proceeds are includable in the decedent's estate. Reg. § 20.2042-1(c)(6). For purposes of determining whether a decedent controlled stock, the decedent will not be attributed ownership of a trust that the decedent did not create with respect to which the decedent was not the deemed owner under the grantor trust income tax rules. Letter Rulings 9808024 (decedent not deemed owner of trust and therefore not attributed stock ownership), 9511046 (decedent attributed stock ownership as deemed owner of QSST). Also, Code § 2035 causes inclusion if the life insurance proceeds are payable to a third party for other than a Reg. § 20.2042-1(c)(6) business purpose and: (a) the corporation, for less than adequate and full consideration, assigns an insurance policy on the stockholder's life and the stockholder then disposes of control of the corporation, or (b) within three years of death the stockholder had a controlling interest in a corporation that owns a life insurance policy on the stockholder's life. Rev. Rul. 90-21. Situation (2) of Rev. Rul. 90-21 reasoned that a shareholder who holds a non-controlling interest would not hold incidents of ownership; however, the facts did not indicate whether the shareholder had any authority to exercise any control over the policy.

<sup>2248</sup> Code § 101(a)(1). However, the death benefit might trigger significant alternative minimum tax (AMT), because book-tax differences generate an AMT preference. Code § 56(g).

<sup>2249</sup> See part II.Q.4.g Establishing Estate Tax Values.

<sup>2250</sup> Reg. § 20.2031-2(f); *Newell v. Commissioner*, 66 F.2d 102 (7<sup>th</sup> Cir. 1933).

<sup>2251</sup> In the *Blount* case, cited in footnote 2374, the Tax Court included the life insurance in the business' value, but the 11<sup>th</sup> Circuit reversed, holding that the buy-sell obligation offset the inclusion in the company's value.

<sup>2252</sup> Code § 264(a)(1). Interest on premiums to buy life insurance is disallowed under Code § 264(a)(4), but it reduces earnings and profits if the payor is a C corporation. Rev. Rul. 2009-25.

<sup>2253</sup> However, in a partnership, part of the sale might constitute ordinary income under Code § 751. See part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.

<sup>2254</sup> Code § 453.

<sup>2255</sup> Code § 453A.



Generally, a transferred policy would be valued for income tax purposes at its fair market value, rather than its Form 712 value.<sup>2256</sup> The IRS takes 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.<sup>2257</sup>

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<sup>2256</sup> *Matthies v. Commissioner*, 134 T.C. 141 (2010 regarding tax years 2000 and 2001), rejected the taxpayer's attempt to use interpolated terminal reserve for income tax purposes, although the rejection appears to have responded to the taxpayer's failure to prove value when engaging in what many people call a "pension rescue" plan that the court considered to be a scheme. The case also held that, if and to the extent that cash surrender value is used, the value does not consider charges imposed on a surrender of the policy. Rev. Proc. 2005-25 applies generally in the context of valuing compensation under Code §§ 79, 83 and 402. Except for split-dollar arrangements and except for employee trusts and annuity plans subject to Code §§ 402(b) and 403(c), Reg. § 1.83-3(e) provides:

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

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

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

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

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

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

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

<sup>2257</sup> See Rev. Ruls. 2009-13 and 2009-14. Commentators disagree with the IRS' position.

For estate and gift tax purposes, the IRS Form 712 value is usually, but not always, appropriate.<sup>2258</sup>

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<sup>2258</sup> Reg. § 25.2512-6(a) provides:

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

Reg. § 20.2031-8(a)(1), (2) provide:

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

Rev. Rul. 78-137 held:

In general, the replacement cost of a single premium policy will determine the value of the policy for gift tax purposes. *United States v. Ryerson*, 312 U.S. 260 (1941), Ct. D. 1488, 1941-1 C.B. 447. The replacement cost is based upon the single premium cost of a comparable policy. *Candler v. Allen*, 43 F.Supp. 435 (M.D. Ga. 1942). Generally, the estate tax and gift tax provisions are in *pari materia*. *Sanford Estate v. Commissioner*, 308 U.S. 39 (1939), Ct. D. 426, 1939-2 C.B. 340.

In order for an insurance policy to qualify as a "comparable contract" within the meaning of section 20.2031-8(a), the policy must provide the same economic benefits as the policy owned by the decedent. *Candler v. Allen*, above at 437. The economic benefits of a single premium life insurance policy consist of an entire bundle of rights including the right to surrender the policy, the right to retain it for investment virtues, the right to borrow the cash surrender value of the policy and the right to payment of the face amount on the death of the insured. *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), Ct. D. 1487, 1941-1 C.B. 445; *Candler v. Allen*, above at 437. All of the economic benefits of the decedent's policy must be taken into consideration. To single out one economic benefit of the decedent's policy and to disregard the others is, in effect, to substitute a different property interest for the one that was owned by the decedent. *Cf. Guggenheim v. Rasquin*, above at 257.

Since the cash surrender value of the replacement policy is less than the cash surrender value of the decedent's policy, the replacement policy does not reflect all of the economic benefits of the policy owned by the decedent. Therefore, the replacement policy is not a "comparable contract" within the meaning of section 20.2031-8(a) of the regulations. Accordingly, in the present case,

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 rules state 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.<sup>2259</sup> The IRS has taken the position that, when an insured transfers a policy on his life to his business co-owner, and his co-owner does the same, the transfer for value rules apply, and the death proceeds will be exempt only to the extent of the new premiums paid after the transfer, with the balance of the proceeds being taxed as ordinary income.<sup>2260</sup> The transfer for value rules do not apply to transfers made to the insured, a corporation in which the insured is an officer or stockholder, a partner of the insured,<sup>2261</sup> a partnership in which the insured is a partner, or where the new owner's basis is determined in whole or in part by reference to the transferor's basis.<sup>2262</sup> A

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the value of the policy owned by A on the life of A's child shall be determined, for Federal estate tax purposes, by reference to a "comparable contract" that reflects all of the economic benefits of the decedent's policy. If, however, information pertaining to a "comparable contract" is not obtainable, the value of the policy shall be determined by reference to the interpolated terminal reserve value of the policy pursuant to section 20.2031-8(a)(2) of the regulations, quoted above.

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

<sup>2259</sup> Code § 101(a)(2).

<sup>2260</sup> Letter Ruling 7734048. 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).

<sup>2261</sup> 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).

<sup>2262</sup> Code § 101(a)(2). Rev. Rul. 2007-13 posited the following situations:

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

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

It held:

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

Note that Rev. Proc. 2011-3, Section 3.01(7) 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,

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.<sup>2263</sup> Similarly, contributing a life insurance policy to a partnership in a Code § 721 nontaxable transfer<sup>2264</sup> is a substituted basis transaction<sup>2265</sup> that is not subject to the transfer for value rules.

In a cross purchase funded by life insurance, consider not only the transfer for value but also income tax rules when an owner enters or exits the ownership group. How will policies on the existing owners be transferred to the new owner? How will policies that a departing owner owns be transferred when that person leaves, and how will policies on that person's life be transferred from the other owners? Consider not only income tax but also Code § 409A nonqualified deferred compensation issues. One might use a Life Insurance LLC to minimize these potentially adverse tax consequences – particularly when new insurance can be obtained.<sup>2266</sup>

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(iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

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

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

The movement of the life insurance contracts from the AC Trust to the AB Trust has two aspects. The first aspect is that, pursuant to the rationale of Rev. Rul. 85-13, Individual A, as a grantor of the AC Trust, as amended, proposes to transfer the life insurance contracts to the AB Trust of which Individual A is the grantor. Thus, this aspect of the transaction cannot be recognized as a sale or exchange for tax purposes because Individual A is treated for income tax purposes as owning the purported consideration both before and after the transaction. The second aspect of the transaction is that Individual B's interest in the AC Trust (in which she is a grantor) is being moved to the AB Trust in which Individual B's husband, Individual A, is the grantor. This action has the result, under § 1041(a), as being treated as a gift to her husband, Individual A, who pursuant to § 1041(b) receives a carryover basis in the life insurance contracts from his wife, Individual B.

<sup>2263</sup> 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.

<sup>2264</sup> See part II.M.3.a General Rule: No Gain on Contribution to Partnership.

<sup>2265</sup> Letter Ruling 201308019.

<sup>2266</sup> See part II.Q.4.h, Life Insurance LLC.

Using split-dollar arrangements<sup>2267</sup> to fund a cross-purchase might also help when unwinding the arrangement. The insured pays the premiums and is deemed the policy owner under the split-dollar regulations,<sup>2268</sup> but the other business owners are entitled to the term insurance component of the death benefit and hold title and all other incidents of ownership with respect to the policy.<sup>2269</sup> If the insured leaves the business, the policy is transferred to the insured (or, preferably, an irrevocable grantor trust established by the insured); the transfer of the policy to the insured is not deemed a transfer for income tax purposes because the insured was already deemed to be the owner.

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

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

1. Generally, income tax applies when buying, selling, or swapping policies. Generally, Code § 1035 nonrecognition of gain when swapping policies applies only when the policies have the same insureds.
2. The transfer for value rules might cause the death benefit to be subject to income tax.<sup>2270</sup>

When life insurance is sold in a taxable transaction, the IRS' position is that:<sup>2271</sup>

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<sup>2267</sup> See part II.Q.4.e Split-Dollar Arrangements.

<sup>2268</sup> Reg. § 1.61-22(c).

<sup>2269</sup> To avoid estate tax inclusion under Code § 2042.

<sup>2270</sup> See text accompanying fns. 2259-2265.

<sup>2271</sup> Rev. Rul. 2009-13, Situation 2 provides the following facts and analysis, which works from Situation 1:

##### **Situation 1**

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

On June 15 of Year 8, A surrendered the contract for its \$78,000 cash surrender value, which reflected the subtraction of \$10,000 of "cost-of-insurance" charges collected by the issuer for periods ending on or before the surrender of the contract. Through that date, A had paid premiums totaling \$64,000 with regard to the life insurance contract. A had neither received any distributions under the contract nor borrowed against the contract's cash surrender value.

A determines taxable income using the cash method of accounting and files income tax returns on a calendar year basis. As of June 15 of Year 8, A was not a terminally ill individual, nor a chronically ill individual, within the meaning of § 101(g)(4).

##### **Situation 2**

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

....

##### **Law and Analysis**

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1. The taxpayer's gain is:

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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).

**Character of income recognized on sale of the life insurance contract**

Unlike Situation 1, which involves the surrender of the life insurance contract to the issuer of the contract, Situation 2 involves an actual sale of the contract. Nevertheless some or all of the gain on the sale of the contract may be ordinary if the substitute for ordinary income doctrine applies.

The Supreme Court has held, under the so-called "substitute for ordinary income" doctrine, that "property" within the meaning of § 1221 does not include claims or rights to ordinary income. Instead, the Court "has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income." *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965). See also *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (consideration received on the sale of a working interest in an oil well represented a substitute for what would have been received in the future as ordinary income, therefore taxable as ordinary income and not capital gain); *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 217, n. 5 (1988) (noting that the "substitute for ordinary income" doctrine had no application to that case). Thus, ordinary income that has been earned but not recognized by a taxpayer cannot be converted into capital gain by a sale or exchange. See also *Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d 1179 (9<sup>th</sup> 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 (7<sup>th</sup> 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 (8<sup>th</sup> Cir. 1962); *Rolf v. Commissioner*, 304 F.2d 450 (3d Cir. 1962); *Commissioner v. Phillips*, 275 F.2d 33 (4<sup>th</sup> 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 (4<sup>th</sup> 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).

- 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"),<sup>2272</sup> and
- Capital gain to the extent of the balance.

2. The selling taxpayer's basis is reduced by the cost of insurance.<sup>2273</sup>

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.<sup>2274</sup> Rev. Rul. 2009-14 discusses tax consequences to the purchaser of a term life insurance policy.

Using a life insurance LLC might solve most or all of these issues.<sup>2275</sup>

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

To the extent that the distributions are nontaxable death benefits,<sup>2276</sup> the rules described below do not apply.<sup>2277</sup>

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<sup>2272</sup> 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.c 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. 2286.

<sup>2273</sup> Commentators strongly disagree with the IRS' position, accusing it of cherry-picking authority. See, e.g., "Ouch, My Head Hurts – Treasury Rules That 'Basis' Is Lower Than 'Investment in the Contract,'" *Northwestern Mutual Advanced Planning Bulletin*, June 2009, citing cases regarding life insurance, including *Arnfeld v. U.S.*, 163 F.Supp. 865 (Ct. Cl. 1958); *Commissioner v. Phillips*, 275 F.2d 33 (4<sup>th</sup> Cir. 1960); *Roff v. Commissioner*, 304 F.2d 450 (3<sup>rd</sup> Cir. 1962); *First National Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8<sup>th</sup> Cir. 1962); and *Gallun v. Commissioner*, 327 F.2d 809 (7<sup>th</sup> Cir. 1964). The *Advanced Planning Bulletin* also cited authority regarding capitalizing expenditures generally, including Reg. § 1.263(a)-4; *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992); and *Federal Express Corp. v. Commissioner*, 412 F.3d 617 (6<sup>th</sup> Cir. 2005). The *Advanced Planning Bulletin* was also published as Finn, "Revenue Rulings 2009-13 & 2009-14 - More on Income Tax Consequences of Surrender and Sale of Life Insurance Policies," *Steve Leimberg's Estate Planning Email Newsletter* as Archive Message #1493 (7/23/2009). Newsletters #1457 (Zaritsky), 1459 (Mancini and Brody), and 1462 (Blattmachr and Gans) also discuss Rev. Ruls. 2009-13 and 2009-14. If a life insurance company demutualizes, none of the policy's basis is allocated to the stock that policyholders receive. *Dorrance v. U.S.*, 807 F.3d 1210 (9<sup>th</sup> Cir. 2015).

<sup>2274</sup> Rev. Rul. 2009-13, Situation 1.

<sup>2275</sup> See parts II.Q.4.h Life Insurance LLC, II.M.3 Buying into or Forming a Partnership, and II.Q.8 Exiting From or Dividing a Partnership.

<sup>2276</sup> Code § 101(a)(1).

<sup>2277</sup> 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),

Generally, distributions (other than tax-free death benefits) from life insurance contracts are not taxable “the extent allocable to the investment in the contract.”<sup>2278</sup> Dividends used to pay premiums are not taxable.<sup>2279</sup> 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<sup>2280</sup> and are treated as distributions when those exceptions apply.<sup>2281</sup> However, distributions and loans generally are taxable if the policy is a “modified endowment contract,” which generally apply when a policy’s premiums are paid too quickly in its initial years.<sup>2282</sup>

Any distributions in excess of “investment in the contract” constitute ordinary income.<sup>2283</sup> However, Code § 1234A might be used to argue that income on surrender should be all capital gain.<sup>2284</sup>

“Investment in the contract”:<sup>2285</sup>

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.

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

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relating to proceeds of life insurance paid at a date later than death, and 104(a)(4), relating to compensation for injuries or sickness.

<sup>2278</sup> Code §§ 72(e)(1), 72(e)(2)(B)(ii).

<sup>2279</sup> Code § 72(e)(4)(B).

<sup>2280</sup> Code § 72(e)(4)(A) includes various exceptions.

<sup>2281</sup> Code § 72(e)(4)(A) includes various exceptions.

<sup>2282</sup> Code § 72(e)(10), using the definition of “modified endowment contract” in Code § 7702A.

<sup>2283</sup> Code § 72(e)(2).

<sup>2284</sup> At the 2015 Heckerling Institute, Larry Brody reported having settled a Tax Court case on this basis.

<sup>2285</sup> Code § 72(e)(6).



aggregate amount of the premiums or other consideration paid for the contract;

- (2) for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and
- (3) the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.

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

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

Consider the following potential abuse:

1. Policy owner sells the policy and receives capital gain treatment.
2. Buyer receives a new “investment in the contract” under Code § 72(g).
3. Buyer cashes in the policy, tax-free.

Given that the buyer has no risk, a policy owner could easily find a straw man to help the policy owner cash in the policy and receive capital gain treatment, avoiding the ordinary income treatment provided by Code § 72(e)(1). Rev. Rul. 2009-13, Situation 2,<sup>2286</sup> 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.<sup>2287</sup>
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<sup>2288</sup> if the buyer expects to receive death benefit in excess of investment in the contract.

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<sup>2286</sup> See fn. 2271.

<sup>2287</sup> See text accompanying fn. 2271.

<sup>2288</sup> Code § 101(a)(2).

#### **II.Q.4.d. Income Tax Issues When the Owner Who Is Not the Insured Dies**

Generally, property an individual owns (including indirectly through a partnership<sup>2289</sup>) receives a new tax basis when that individual dies if that property is included in that individual's estate for estate tax purposes.<sup>2290</sup>

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.d.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.<sup>2291</sup> 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.<sup>2292</sup> Regulations provide:<sup>2293</sup>

**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."<sup>2294</sup>

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<sup>2289</sup> 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.

<sup>2290</sup> Code § 1014, which applies to more than just what this sentence describes.

<sup>2291</sup> Code § 1014(b)(9); Reg. § 1.1014-2(b)(3)(i).

<sup>2292</sup> Code § 1014(c).

<sup>2293</sup> Reg. § 1.691(a)-1(b).

IRD does not include “items which are excluded from gross income under subtitle A.”<sup>2295</sup>

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)<sup>2296</sup> or excluded from income (if received as a nontaxable death benefit).<sup>2297</sup> 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:<sup>2298</sup>

- (1) whether the decedent entered into a legally significant arrangement regarding the subject matter of the sale,<sup>5</sup>
- (2) whether the decedent performed the substantive (nonministerial) acts required as preconditions to the sale,<sup>6</sup>
- (3) whether there existed at the time of the decedent's death any economically material contingencies which might have disrupted the sale,<sup>7</sup> and
- (4) whether the decedent would have eventually received the sale proceeds if he or she had lived.<sup>8</sup>

74 T.C. at 639-41.

<sup>5</sup> 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 (5<sup>th</sup> Cir. 1981) (the right to income need not be legally enforceable).

<sup>6</sup> “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*,

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<sup>2294</sup> Reg. § 1.451-1(a).

<sup>2295</sup> Reg. § 1.691(a)-1(c).

<sup>2296</sup> Code § 72(e).

<sup>2297</sup> See *fn.* 2276-2277.

<sup>2298</sup> *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8<sup>th</sup> Cir. 1981), summarizing the Tax Court’s holding.

*supra*, 74 T.C. at 640. Compare M. Ferguson, J. Freeland & R. Stephens, *Federal Income Taxation of Estates and Beneficiaries*, *supra*, 180-84 (“[E]ven where the property has been made the subject of a binding, executory contract of sale, if the benefits and hazards of ownership are still possessed by the decedent at his death, the property is entitled to a § 1014(a) basis in the hands of his estate, and his negotiated profit will not be taxed to his estate (or to anyone) under § 691 when the sale is completed after his death.”) (footnote omitted), with Gordon, *Income in Respect of a Decedent and Sales Transactions*, 1961 *Wash. U.L.Q.* 30, 37 (§ 691 should apply to sale proceeds from sales which at the time of the decedent's death are incomplete “only as to delivery of the *res* and receipt of the purchase price”).

<sup>7</sup> 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).

<sup>8</sup> 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:<sup>2299</sup>

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:<sup>2300</sup>

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.

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

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<sup>2299</sup> 74 T.C. at 643-44.

<sup>2300</sup> 74 T.C. at 641.

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 than will never decrease. Rev. Rul. 2009-13 takes 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.<sup>2301</sup> 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),<sup>2302</sup> 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"<sup>2303</sup> 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.<sup>2304</sup> Furthermore, Rev. Rul. 2009-13

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<sup>2301</sup> See fn. 2271.

<sup>2302</sup> 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.

<sup>2303</sup> 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 (6<sup>th</sup> 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 (6<sup>th</sup> 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.

<sup>2304</sup> 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

does not say that inside build-up creates gain; it merely says that inside build-up recharacterizes part or all of the gain on sale of the policy as ordinary income.

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.<sup>2305</sup>

#### **II.Q.4.d.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; Transfer for Value Rules. 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<sup>2306</sup> do not make the death benefit taxable.<sup>2307</sup>

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:

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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.

<sup>2305</sup> Rev. Rul. 75-125 (which the Rev. Rul. 92-47 cited as being food 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. 2298), 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.

<sup>2306</sup> See part II.Q.4.a Funding the Buy-Sell; Transfer for Value Rules, especially fns. 2259-2265.

<sup>2307</sup> 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.”

- “We never undertake to make a Code § 72(g) adjustment, because we don’t want to be bothered with it.” If the insurance company answers that way, ask whether they will honor a request to check the box “taxable amount not determined” so that the taxpayer is not required to disprove what otherwise would be an incorrect Form 1099.
- “We don’t want to undertake to make a Code § 72(g) adjustment, but we will do it if a sale violates the transfer for value rules; in that case, we need to tell the IRS the taxable amount at death, so it is worth it to track this.” To obtain that Form 1099 reporting, the policy owner’s estate might sell the policy in a transaction that violates the transfer for value rules. One might follow that transfer by a transfer to the insured, which would cleanse the transfer for value taint (perhaps other cleansing opportunities are available as well). For example, Dad owns policy on Daughter’s life. Dad dies. Dad’s estate sells the policy to Son, violating the transfer for value rules (unless an exception applies) and triggering the insurance company tracking the new “investment in the contract.” Then Son sells the policy to Daughter (the insured); this transaction would not generate any gain to the extent of Son’s basis due to his purchase from Dad’s estate, and Daughter’s purchase cleanses the transfer-for-value taint because she is the insured. However, one might decide that taking all these steps is not worth the effort and simply ask whether the insurance company will honor a request to check the box “taxable amount not determined.”

#### **II.Q.4.e. Split-Dollar Arrangements**

##### **II.Q.4.e.i. Split-Dollar Generally**

A split-dollar arrangement is an arrangement in which one party pays part or all of the premiums and one or more of the economic rights to the policy (cash value, death benefits, etc.) are divided. An employer cannot bundle together a number of such arrangements and call them deductible welfare benefit plans; doing so subjects the employer to penalties.<sup>2308</sup> The IRS has an audit techniques guide on split-dollar arrangements.<sup>2309</sup>

The IRS created split-dollar rules before the U.S. Supreme Court found that interest could be imputed on loans and before Code § 7872 was enacted. During that period, the employer would retain the premiums it paid when the arrangement terminated (whether by death or by unwinding the arrangement – the latter referred to as a “rollout”), and the employee’s beneficiary (or employee on rollout) would receive the death benefit (or cash

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<sup>2308</sup> *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (2015). This case involved seven taxpayers, and the parties in approximately 40 other cases agreed to be bound by the result of this case. Notice 2007-83 announced that the IRS would target welfare benefit plans funded by life insurance. Notice 2007-84 announced that the IRS would target certain multi-employer welfare benefit plans. Program Manager Technical Advice 2015-11 explains how to apply the 30% accuracy-related penalty under Code § 6662A(c), to taxpayers who didn’t follow the requirement of Notice 2007-83 to disclose participation in a listed transaction that used cash value life insurance policies to provide welfare benefits in a purported Code § 419 plan.

<sup>2309</sup> See [http://www.irs.gov/Businesses/Corporations/Split-Dollar-Life-Insurance-Audit-Technique-Guide-\(03-2005\)](http://www.irs.gov/Businesses/Corporations/Split-Dollar-Life-Insurance-Audit-Technique-Guide-(03-2005)) and [www.irs.gov/businesses/corporations/article/0,id=136548,00.html](http://www.irs.gov/businesses/corporations/article/0,id=136548,00.html).

value in the case of a rollout) after reimbursing the premiums paid.<sup>2310</sup> It needed a mechanism to tax long-term interest-free loans, which is what split-dollar was essentially at that time, but without a promissory note. Under that system, the employer was treated as owning the policy and providing taxable economic benefits to the employee each year equal to the value of one year of life insurance protection. This treatment applied whether the employer or employee owned the policy. To avoid estate tax on the death benefit, an irrevocable life insurance trust (“ILIT”) would own the policy, so that each year’s imputed income to the employee was also a gift to the trust. Eventually, the arrangement would be undone before the employee’s death, whether because the annual life insurance protection became too high as the employee got older, because the parties wanted to simplify the arrangement, or termination of employment. Often, the policy’s cash value exceeded the premiums paid; and some taxpayers took the position that receipt of the life insurance policy, which had a cash value in excess of the premiums reimbursed to the employer on rollout, was not a taxable event, because the employee (or life insurance trust) already had legal title to the policy. The government was not happy with the taxpayer using the tax fiction of the employer owning the policy before rollout and then ignoring that tax fiction at rollout and responded by promulgating the regulatory regime described below.

Now split-dollar arrangements are governed by Reg. § 1.7872-15, under which premium payments generally are treated as loans<sup>2311</sup> generally requiring an election,<sup>2312</sup> or Reg. § 1.61-22 (the “economic benefit regime”), under which generally one person is treated as owning all of the policy’s cash value and the other person pays, or is treated as paying, for one-year term life insurance to the extent of the death benefit not allocated to the owner or deemed owner.

In the economic benefit regime, generally the owner and non-owner receive tax-free death benefits. The owner applies Code § 72 to any distributions that are not death benefits; even a deemed owner is treated as the real owner under Code § 72. See part II.Q.4.e.ii.(b) Treatment of Split-Dollar Arrangement. The other version involves the premium payor being treated as making loans to the policy owner; this requires additional documentation to be filed with the IRS if the loans are the equivalent of nonrecourse loans, the deadline for which is eligible for Code § 9100 relief in appropriate

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<sup>2310</sup> The reimbursement obligation was nonrecourse – paid only out of the policy and not personally by the employee.

<sup>2311</sup> Stated interest that is not payable annually triggers the Code § 1272 original issue discount (OID) rules. See Reg. §§ 1.7872-15(a)(1) (referring to OID rules as potentially applying), 1.1273-1(a) (OID is “the excess of a debt instrument’s stated redemption price at maturity over its issue price”), 1.1273-1(b) (“stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments”), and 1.1273-1(c)(1)(i) (qualified stated interest payments must be made at least annually).

<sup>2312</sup> If and to the extent that a split-dollar loan is repayable solely out of life insurance cash values, part or all of the interest might be considered contingent interest that is disregarded, leading to a below-market loan. Reg. § 1.7872-15(d), (j). To avoid that consequence, one might consider making a Reg. § 1.7872-15(d)(2) election when the first loan is made under the split-dollar agreement. In appropriate circumstances, Code §9100 relief might extend the deadline for filing the election; see, e.g., Letter Ruling 201041006 and other rulings.



circumstances (see Letter Ruling 201041006, summarizing the deadline as well as the issue and then granting relief).

For the treatment of the economic benefit regime before Reg. § 1.61-22 was promulgated, agreements entered into on or before September 17, 2003 are instead subject to IRS Notices 2001-10 and 2002-8<sup>2313</sup> and Rev. Rul. 2003-105, so long as they are not “materially modified.” Reg. § 1.61-22(j) lists some unenlightening safe harbors for what does not constitute a material modification. “Material modification” for this purpose includes changes that would not constitute a material modification under Code § 101(j) (employer-owned life insurance)<sup>2314</sup> or 264(f) (limiting deductions for interest expense allocable to unborrowed policy cash value).<sup>2315</sup>

The economic benefit regime might also trigger the harsh nonqualified deferred compensation rules of Code § 409A.<sup>2316</sup> Although the Code § 409A risk described in fn. 2316 is much smaller under Reg. § 1.61-22 than under prior law, be careful to consider it in either case.<sup>2317</sup>

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<sup>2313</sup> Notice 2002-8 discusses the extent to which changes in the IRS’ view might affect arrangements then in effect:

**VI. Effect On Other Documents**

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

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

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

<sup>2314</sup> See part II.Q.4.f Income Tax Trap for Business-Owned Life Insurance, especially part II.Q.4.f.i Analysis of Code § 101(j).

<sup>2315</sup> Notice 2008-42.

<sup>2316</sup> See text accompanying fns. 2244-2245.

<sup>2317</sup> Reg. § 1.409A-1(b)(1) provides:

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

Generally, for post-2003 split-dollar agreements, the employee will have to pay for the policy’s value under part II.Q.4.e.ii.(b) Treatment of Split-Dollar Arrangement under Reg. § 1.61-22; however, one might want to clarify that the employee will need to pay the greater of the amount provided under the regulations or the policy’s fair market value, which as a practical matter would likely to be the value on Form 712. For pre-2003 agreements that are not materially modified, the employee paying the cash surrender value would suffice; see fn. 2256. Given that these older arrangements might not require the employee to pay the cash surrender value, one should look to Notice 2007-34 to try to make the policy qualify for being grandfathered from Reg. § 1.61-22 and comply with Code § 409A.

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

The loan regime can be somewhat unwieldy, in that each year's premium requires a separate loan. Furthermore, the economic benefit regime tends to be most beneficial to the non-owner in the policy's early years, in which the premiums paid tend to exceed the policy's cash value. Considering these issues, one might consider starting with the economic benefit regime and the switching to the loan regime when cash value approaches premium paid. This switching approach avoids administering and accruing interest on multiple loans in the policy's early years and allow cash value increases after that point to benefit the party that originally was the non-owner. By the time the switch occurs, the policy might very well be earning enough dividends to pay premiums, perhaps avoiding the need to administer multiple loans to pay for those future premiums. If the original non-owner is an irrevocable trust, during the economic benefit phase (and of course later) the grantor can make annual exclusion gifts to the trust and perhaps even use leveraged estate planning techniques<sup>2318</sup> to grow the trust so that the trust can afford to pay future premiums and perhaps even retire the split-dollar loans.

#### **II.Q.4.e.ii. Technical Details of the Split-Dollar Economic Benefit Regime**

##### **II.Q.4.e.ii.(a). Is the Arrangement a Split-Dollar Arrangement?**

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

Reg. § 1.61-22(b)(1) provides:

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

- (i) Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract;
- (ii) At least one of the parties to the arrangement paying premiums under paragraph (b)(1)(i) of this section is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and

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<sup>2318</sup> See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

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

Even if the above requirements are not met, any arrangement between an owner and a non-owner of a life insurance contract is treated as a split-dollar life insurance arrangement if it qualifies as a certain compensatory arrangement or shareholder arrangement.<sup>2319</sup>

The following constitutes a split-dollar compensatory arrangement:<sup>2320</sup>

- (A) The arrangement is entered into in connection with the performance of services and is not part of a group-term life insurance plan described in section 79;<sup>2321</sup>
- (B) The employer or service recipient pays, directly or indirectly, all or any portion of the premiums; and
- (C) Either-
- (1) The beneficiary of all or any portion of the death benefit is designated by the employee or service provider or is any person whom the employee or

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<sup>2319</sup> Reg. § 1.61-22(b)(2)(i).

<sup>2320</sup> Reg. § 1.61-22(b)(2)(ii).

<sup>2321</sup> *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (2015), discussed this requirement in depth, including the requirement of Reg. § 1.79-1(a)(4) that a group term arrangement not involve “individual selection”:

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

In contrast, if a group-term policy allows employees to buy additional pure term insurance on an after-tax basis without any such purchases affecting the employer-provided group plan, the employees’ independent choices do not affect the employer-provided group plan’s qualification as such. Letter Ruling 201542003.

service provider would reasonably be expected to designate as the beneficiary; or<sup>2322</sup>

(2) The employee or service provider has any interest in the policy cash value of the life insurance contract.<sup>2323</sup>

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<sup>2322</sup> *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (2015), discussed this requirement in depth:

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

<sup>2323</sup> *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (2015), discussed this requirement in depth:

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

We also find important to our just-stated conclusion that the plan benefits were set to be fully vested either when a shareholder/employee satisfied the vesting requirements that he or she chose

The following constitutes a split-dollar shareholder arrangement:<sup>2324</sup>

- (A) The arrangement is entered into between a corporation and another person in that person's capacity as a shareholder in the corporation;
- (B) The corporation pays, directly or indirectly, all or any portion of the premiums; and
- (C) Either-
  - (1) The beneficiary of all or any portion of the death benefit is designated by the shareholder or is any person whom the shareholder would reasonably be expected to designate as the beneficiary; or
  - (2) The shareholder has any interest in the policy cash value of the life insurance contract.

#### **II.Q.4.e.ii.(b). Treatment of Split-Dollar Arrangement under Reg. § 1.61-22**

The rules below apply for purposes of the income tax, the gift tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA).<sup>2325</sup> Generally, the split-dollar economic benefit regime<sup>2326</sup> applies to any arrangement that is not subject to the split-dollar loan regime.<sup>2327</sup> It also applies to a loan arrangement if the following requirements of Reg. § 1.61-22(b)(3)(ii) apply:

- (A) The arrangement is entered into in connection with the performance of services, and the employer or service recipient is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(1) of this section); or
- (B) The arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donor is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(2) of this section).

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

<sup>2324</sup> Reg. § 1.61-22(b)(2)(iii).

<sup>2325</sup> Reg. § 1.61-22(a)(1) provides the purposes.

<sup>2326</sup> The regulatory framework for the split-dollar economic benefit regime is valid. *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (2015).

<sup>2327</sup> Reg. § 1.61-22(b)(3)(i).

Generally, “[w]ith respect to a life insurance contract, the person named as the policy owner of such contract generally is the owner of such contract.”<sup>2328</sup>

However:<sup>2329</sup>

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

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

Similarly, in a donor-donee economic split-dollar agreement, if the donee is designated the owner of the life insurance policy, then the donee will be treated as the owner for tax purposes if the donee has any interest other than current life insurance protection. Although the donee having actual ownership of the policy would seem risky for this reason, such an arrangement might save estate tax if the donor is not the insured, as described in part II.Q.4.e.iii Estate Tax Consequences of Split-Dollar Agreements.<sup>2330</sup>

For these purposes:<sup>2331</sup>

the amount of the current life insurance protection provided to the non-owner for a taxable year (or any portion thereof in the case of the first year or the last year of

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<sup>2328</sup> Reg. § 1.61-22(c)(1)(i), which further provides:

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

<sup>2329</sup> Reg. § 1.61-22(c)(1)(ii)(A).

<sup>2330</sup> Especially fns. 2341-2343.

<sup>2331</sup> Reg. § 1.61-22(d)(3)(i).

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

In applying these rules, the “non-owner (and the owner for gift and employment tax purposes) must take into account the full value of all economic benefits . . . , reduced by the consideration paid directly or indirectly by the non-owner to the owner for those economic benefits.”<sup>2332</sup>

The requirement that the non-owner receive only current life insurance protection means that the non-owner cannot have any other economic benefits, such as current or future access to cash value.<sup>2333</sup> Policy cash value excludes surrender charges or other similar charges or reductions and includes policy cash value attributable to paid-up additions.<sup>2334</sup> A non-owner has current access to that portion of the policy cash value (A) to which the non-owner has a current or future right and (B) that currently is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors.<sup>2335</sup> Note that the policy's being inaccessible to the owner is not enough

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<sup>2332</sup> Reg. § 1.61-22(d)(1). Furthermore:

Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons (including a non-owner or non-owners), the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's child).

See text accompanying fn. 2333 for the economic benefits described in this regulation.

<sup>2333</sup> Reg. § 1.61-22(d)(2) provides:

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

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

<sup>2334</sup> Reg. § 1.61-22(d)(4)(i).

<sup>2335</sup> Reg. § 1.61-22(d)(4)(ii).

to attribute cash value to the non-owner; the non-owner must also have a current or future right to the cash value.<sup>2336</sup>

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<sup>2336</sup> See fns. 2341-2343, in which the cash value seemed to be as inaccessible to the donor as it could possibly be, and the court dismissed out-of-hand arguments about inaccessibility because the non-owner had no current or future right to any part of the cash value. The split-dollar agreement provided:

**Section 2.01. Policy Ownership.**

(a) The Trust be the sole and absolute owner of the Policy, and may exercise all ownership rights granted to the owner thereof under the term of the Policy, except as otherwise provided in and limited by this Agreement.

(b) It is the intention of the parties to this Agreement and the purpose of the Collateral Assignment that the Trust shall retain all rights that the Policy grants to the owner thereof, except as otherwise provided in and provided by this Agreement. The sole right of the Donor under this Agreement and under the Collateral Assignment shall be to be repaid the amount due to Donor under this Agreement. Specifically, but without limitation, the Donor shall neither have nor exercise any right as collateral assignee of the Policy that could in any way defeat or impair the Trust's right to receive the Policy Cash Value or the death benefit of the Policy in excess of the total amount due to the Donor under this Agreement. All provisions of this Agreement and of the Collateral Assignment shall be construed so as to carry out such intention and purpose.

**Section 2.02. Dividends.** All dividends declared and paid on the Policy shall be applied as the Trust shall deem appropriate.

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

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

2. It is expressly agreed that the Assignee's interest in the Policy under and by virtue of this Assignment shall be limited to the following specific rights, and no others: (a) the right to be paid the amount due to the Assignee under the Agreement by recovering said amount directly from the Insurer out of the net death proceeds of the Policy; upon the death of the Insured; and (b) the right to be paid the amount due to the Assignee under the Agreement by recovering said amount from the Assignor out of the Policy Cash Value (as defined in the Agreement), in the event the Policy is surrendered or cancelled by the Assignor or in the event the Agreement is terminated during the Insured's lifetime. The Assignee shall have no other rights or powers in and to the Policy as a result of the assignment of the Policy to the Assignee hereunder, and specifically shall not have the right or power to borrow against or obtain loans or advances on the Policy, make withdrawals from the Policy, nor cancel or surrender the Policy.

3. Except as otherwise provided in this Assignment and the Agreement, the Assignor shall specifically retain all incidents of ownership in and to the Policy, including, but not limited to: (a) the sole right to cancel or surrender the Policy at any time provided by the terms of the Policy and at such other times as the Insurer may allow; (b) the sole right to collect and receive all distributions or shares of surplus, dividend deposits or additions to the Policy now or hereafter made or apportioned thereto, and to exercise any and all options contained in the Policy with respect thereto; (c) the sole right to exercise all non forfeiture rights permitted by the return of the Policy or allowed by the Insurer and to receive all benefits and advantages derived therefrom; (d) the sole right to designate and change the beneficiary of the Policy (for any amount in excess of the amount to the Assignee under the Agreement); (e) the sole right to elect any optional mode of settlement permitted by the Policy or allowed by the Insurer; and (c) the sole right to collect



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

For death benefits (noting that Code § 101(a) exempts death benefits from income taxation except to the extent that the transfer for value rules apply, if at all):<sup>2337</sup>

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

Except for death benefits:<sup>2338</sup>

[A]ny amount received under a life insurance contract that is part of a split-dollar life insurance arrangement ... is treated, to the extent provided directly or indirectly to a non-owner of the life insurance contract, as though such amount had been paid to the owner of the life insurance contract and then paid by the owner to the non-owner. The amount received is taxable to the owner in accordance with the rules of section 72. The non-owner (and the owner for gift tax and employment tax purposes) must take the amount described in paragraph (e)(3) of this section into account as a payment of compensation, a

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

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

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

<sup>2337</sup> Reg. § 1.61-22(f)(3).

<sup>2338</sup> Reg. § 1.61-22(e)(1).

distribution [from a corporation],<sup>2339</sup> a contribution to capital, a gift, or other transfer depending on the relationship between the owner and the non-owner.

The owner is the only party who is credited with “investment in the contract under Code § 72(e)(6).<sup>2340</sup>

Reg. § 1.61-22(g) provides rules for unwinding the arrangement so that the non-owner becomes the owner.

### **II.Q.4.e.iii. Estate Tax Consequences of Split-Dollar Agreements**

Note that the split-dollar economic benefit regime regulations do not apply for estate tax purposes. Apparently taking advantage of this gap, *Estate of Morrissette v. Commissioner*<sup>2341</sup> upheld a taxpayer’s heavily discounted generational split-dollar agreement<sup>2342</sup> when the decedent bequeathed her interest to the other party in the split-dollar arrangement.<sup>2343</sup> In that case, the mother funded life insurance owned by

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<sup>2339</sup> The actual text refers to Code § 301.

<sup>2340</sup> Reg. § 1.61-22(f)(2)(ii) provides:

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

<sup>2341</sup> 146 T.C. No. 11 (2016). For a complete discussion, see S. Gorin & H. Zaritsky, “Tax Court Approves Some Key Issues with Intergenerational Split-Dollar Arrangements,” 28 Probate Practice Reporter 1 (June 2016). For a link to various selected documents filed with the Tax Court, including the split dollar agreement and appraisal the IRS viewed as representative of the arrangements, see <http://tcinstitute.com/rv/ff002894cb41394cda173f9fe7469759eae604bd>. In *Estate of Cahill v. Commissioner*, Tax Court Docket No. 10451-16, a petition filed May 3, 2016 indicates issues relating to valuation, Code §§ 2036, 2038 and 2703, among others – issues that the *Morrissette* court did not discuss. In *Estate of Levine v. Commissioner*, Tax Court docket no. 9345-15, a July 13, 2016 order granted summary judgment to the taxpayer because the parties agreed that *Morrissette* controlled, with the IRS preserving its right to appeal, indicating that it continued to disagree with *Morrissette*.

<sup>2342</sup> Under the split-dollar rules, the decedent was the deemed owner of policies on younger insureds. Such an arrangement is referred to as “generational” because the insured is expected to outlive the decedent by a significant number of years. That the decedent’s estate has to wait for many years to collect what it is owed and must also continue to expend funds during that time might cause the value of the decedent’s economic rights to be discounted. However, the decedent’s estate would benefit from the growth in the policy’s cash value and would not bear the mortality charge (except to the extent that the mortality charge exceeded the rates under the IRS’ Table 2001 rates), so it is unclear how much the policy should be discounted.

<sup>2343</sup> The IRS apparently argued that bequeathing the decedent’s split-dollar interest to the other party to the contract made the restrictions illusory. From the opinion:

Respondent argues that the Dynasty Trusts had a direct or indirect right in the cash values of the insurance policies by virtue of the terms of the 2006 Amendment to the CMM Trust. Under that amendment, the CMM Trust’s interest in the cash values of the policies would pass to the Dynasty Trusts or directly to Mrs. Morrissette’s sons or their heirs upon her death. However, because the

irrevocable life insurance trusts (“ILITs”) to fund cross purchase buy-sell obligations that her children had to each other. Because the mother had to wait until her children died to receive cash on the split-dollar receivables and the ILITs had full control over the policies, the mother’s estate tax return reported that her right to receive the almost \$30 million she invested was worth only approximately \$7.5 million. Because the split-dollar receivable would have a low basis, repayment would have generated significant income tax; by bequeathing the receivable to the other party to the agreement, the mother might have prevented that result.<sup>2344</sup>

Also consider potential estate tax inclusion when the insured also controls an employer that is a party to the split-dollar agreement. Because part of the death benefit is not payable to the employer,<sup>2345</sup> the IRS might argue that the insured has incidents of

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CMM Trust was a revocable trust with respect to Mrs. Morrisette, she retained an absolute right to alter the CMM Trust throughout her lifetime. Accordingly, the Dynasty Trusts did not have a legally enforceable right to the cash values of the policies during the lifetime of the grantor. Furthermore, the split-dollar life insurance arrangements did not require the CMM Trust to distribute the receivables to the Dynasty Trusts. Rather, Mrs. Morrisette retained the right to receipt of the receivables.

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

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

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

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

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

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

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

- The purchase of the policies was for a legitimate and significant nontax reason [my assumption that the *Bongard* test might have been in the court’s mind] – to fund a buy-sell agreement.
- The donor lived 4 years after the arrangement was made.
- The gift tax returns used the IRS’ Table 2001 rates instead of any alternative term rates provided by the insurance company.

<sup>2344</sup> Presumably the bequest of the receivable or even a note under the loan regime would not generate income tax. Bequeathing a note (other than a note received in an installment sale) does not trigger cancellation of indebtedness income to the debtor; see fn. 4003, found in part III.B.3.a Promissory Notes.

<sup>2345</sup> If all of the death benefit is payable to the employer or used for the employer’s business purpose, the insurance policy is not included in the insured’s estate by reasons of incidents of ownership, although the death benefit might very well affect the employer’s value that is included in its deceased owner’s estate. See part II.Q.4.a Funding the Buy-Sell; Transfer for Value Rules, especially fn. 2247.

ownership over the policy that is subjected to the split-dollar arrangement. To avoid such an argument, the split-dollar agreement and any collateral assignments might limit the employer's rights to just those provided in the split-dollar agreement.<sup>2346</sup> Although that approach would work for the split-dollar loan regime, it might not work so well for the economic benefit regime. The economic benefit regime provides that the non-owner is deemed to have current access to that portion of the policy cash value to which the non-owner has a current or future right and that currently is inaccessible to the owner.<sup>2347</sup> In other words, if the employer is generally the deemed owner but cannot access the cash value, the other party to the split-dollar agreement is deemed to benefit from that cash value if the other party has a current or future right to part of the cash value. Thus, the approach suggested in fn. 2346 risks being recharacterized as being owned by the employee (and therefore the employer's premium being considered paid to the employee to the extent not attributable to the employer's retained rights to absolutely control cash value) unless the split-dollar agreement is absolutely tight about the employer being entitled to the full cash value. For those less than absolutely confident that the agreement, when using the economic benefit regime consider making the case that the entire arrangement is for the employer's business purpose – the employer receives the employer's portion of the death benefit, and the balance of the death benefit was provided through reasonable compensation for valuable services that the insured provided to the

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<sup>2346</sup> For example, Letter Ruling 9651017 held:

Under the split-dollar agreement in the present case, X is expressly prohibited from borrowing against any part of the policy. In addition, the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the trustee of Trust. Accordingly, we conclude, that X will possess no incidents of ownership in the policy acquired by the Trust. See Rev. Rul. 76-274, 1976-2 C.B. 278, modified by Rev. Rul. 82-145, 1982-2 C.B. 213.

Letter Ruling 9651030 had the same or similar language. Letter Ruling 9511046 elaborated:

Under the split-dollar agreement in the present case, the corporation will, however, hold no incidents of ownership. The corporation will have no defacto ability to force the trustee to borrow against the policy because the corporation is required to make the necessary premium payments for the duration of the trust. The power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the third party trustee of the irrevocable trust and are not attributable to the corporation. Accordingly, although the surviving spouse will hold control of the corporation for purposes of section 20.2042-1(c)(6), the corporation will hold no incidents of ownership in the second-to-die life insurance policy, and, thus, no incidents of ownership in the policy will be attributable to the surviving spouse.

Letter Ruling 9348009 held:

The facts in this case indicate that the Company's economic interest in the policy is limited to that of irrevocably designated beneficiary of that portion of the proceeds that is equal to the cash surrender of the policy. Additionally, we assume that no agreement or other factors exist that would cause the value of the decedent's stock holdings in the corporation not to be taken into account for purposes of section 2031. Under these circumstance, because the Company possesses no rights the exercise of which would impact that portion of the proceeds payable to a beneficiary other than the Company, the Company cannot be said to possess any incidents of ownership in the policy of the type that would be attributable to the surviving spouse under section 20.2042-1(6) of the regulations.

<sup>2347</sup> Reg. § 1.61-22(d)(2)(ii) - see fns. 2333 and 2335 for text of the relevant regulations.

employer or through sharing the premium. However, *Morrisette*'s approval of a split-dollar policy as being solely owned by the premium payer (other than current life insurance protection) will boost the confidence of practitioners regarding the ability to draft agreements without risking the named owner being treated as the owner for income and gift tax purposes; see fn. 2341.

For donor-donee arrangements on the life of the insured, naming the donor as owner is not available. If the donor is the insured, one must draw up an absolutely tightly woven split-dollar agreement preventing the donor from having incidents of ownership, if using the economic regime (as in fn. 2341); those who are risk averse should use the loan regime. If the donor is not the insured, preventing the donor from having incidents of ownership is not important; one can then either name the donor as owner to take a conservative approach or, using a tightly woven split-dollar to try to secure valuation discounts,<sup>2348</sup> name the donee as the owner.

Lee Slavutin suggests the following guidelines for drafting generational split dollar agreements:<sup>2349</sup>

1. Clearly state that the purpose of the split dollar agreement is to “fund a permanent life insurance policy for estate liquidity or business succession, for example.”
2. Add a preliminary recital that the agreement is intended to qualify as an economic benefit arrangement under Reg. § 1.61-22 and that the ONLY benefit intended to be provided to the “donee” trust is life insurance protection.
3. Do NOT give the donee trust the right to borrow against the cash value.
4. At termination or death, make sure that the donor gets the GREATER of cash value or premiums paid.
5. The donor should be REQUIRED to pay all premiums. The donee has no obligation to pay premiums. If premiums are prepaid, there will be no additional benefit to the donee trust.
6. Do not mention the disposition of the receivable at death. Otherwise, it might be construed as an additional benefit to the donee trust.

#### **II.Q.4.f. Income Tax Trap for Business-Owned Life Insurance**

##### **II.Q.4.f.i. Analysis of Code § 101(j)**

Beware that an employer-owned life insurance contract might not qualify for the usual exclusion from regular income tax.<sup>2350</sup> An “employer-owned life insurance contract” (a

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<sup>2348</sup> See fns. 2341-2343.

<sup>2349</sup> “A Post-*Morrisette* Roadmap for Drafting Intergenerational Split Dollar Agreements,” *Steve Leimberg's Estate Planning Email Newsletter* - Archive Message #2414 (5/12/2016).

<sup>2350</sup> Code § 101(j).

term that applied to much more than one would think) does not receive the exclusion unless certain notice and consent requirements are met.<sup>2351</sup>

An “employer-owned life insurance contract” is a life insurance contract that (i) is owned by a person engaged in a trade or business and under which such person (or certain related party) is directly or indirectly a beneficiary under the contract, and (ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.<sup>2352</sup> An “applicable policyholder” means, with respect to any employer-owned life insurance contract, the person described in the preceding sentence who owns the contract<sup>2353</sup> at the time it is issued.<sup>2354</sup>

“Employee” includes a “highly compensated employee” under Code § 414(q),<sup>2355</sup> and Code § 414(q)(1)(A) pulls in people who own at least 5% of the company.<sup>2356</sup> Thus, an owner who is not an employee is an “employee” for purposes of this rule by being a 5% owner.

The notice and consent requirements are met if, before the issuance of the contract, the employee (A) is notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued, (B) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (C) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.<sup>2357</sup> The only way that this requirement makes any sense is if the policy was issued to the person treated as the insured's employer under these rules - this requirement would be impossible to satisfy if it was issued to the insured or someone else because the person treated as an employer might not even know about the policy. Thus, “applicable policyholder” should mean the person to whom the policy is issued when the insured is an “employee” of that person.<sup>2358</sup>

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<sup>2351</sup> Code § 101(j)(1), (2).

<sup>2352</sup> Code § 101(j)(3)(A).

<sup>2353</sup> Code § 101(j)(3)(B)(i).

<sup>2354</sup> The qualification “at the time it is issued” is not mentioned in any particular authority but appears to be implicit in the statutory scheme. See the text accompanying fn. 2358.

<sup>2355</sup> Code § 101(j)(5).

<sup>2356</sup> Notice 2009-48, A-8 provides:

Section 101(j)(4) provides no exception that would excuse a wholly-owned corporation and its employee-owner from the notice and consent requirements that otherwise apply, nor can actual knowledge alone substitute for the statutory requirement that notice and consent be ‘written.’ Moreover, the requirement that notice and consent be written avoids factual controversies that otherwise could result where, for example, the sole owner of a corporation delegates financial matters to an employee.

<sup>2357</sup> Code § 101(j)(4).

<sup>2358</sup> Notice 2009-48, A-1, further below, clarifies that the person to whom this sentence refers generally is the entity that “employs” the insured rather than an owner of the entity and that the entity is treated as owning a policy owned by a grantor trust with respect to which the entity is the deemed owner.

A life insurance-funded buy-sell agreement might be structured to comply with these rules, in case the parties forget to do the required notice and consent.<sup>2359</sup> It also would guard against error in my suggestion that “applicable policyholder” is limited to being the person to whom the policy is issued when the insured is an “employee” of that person.

These rules impose various notice and other requirements that in most cases will not be a practical obstacle to implementing buy-sell agreements if signed before the application is signed.<sup>2360</sup> The employer might be able to cure a failure before the due date of its return for the year in which the policy was issued if the insured has not died yet.<sup>2361</sup>

Clients should obtain the insured’s written consent before the life insurance application is signed.

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<sup>2359</sup> One might consider provisions such as that found in part II.Q.4.f.ii Consent Integrated into Operating Agreement. The sample is an attempt to be a catch-all in case clients do not follow the recommended procedure. Letter Ruling 201217017 approved what appears to have been a similar provision in a corporate buy-sell agreement:

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

The ruling concluded:

...considering all of Taxpayer’s documentation as a whole, for the Contracts listed in the Appendix, all of the requirements of § 101(j)(4) were met before the issuance of the Contracts:

- a) through the Agreement and the Application, each Shareholder was notified in writing that Taxpayer intended to insure the Shareholder’s life;
- b) through the Application, each Shareholder was notified in writing of the maximum face amount for which the Shareholder could be insured at the time the Contract was issued, in dollars;
- c) by signing both the Agreement and the Application, each Shareholder consented to being insured under the Contract;
- d) by signing the Agreement, each Shareholder consented that such coverage may continue after the Shareholder terminates employment; and
- e) through the Agreement and the Application, each Shareholder was informed in writing that Taxpayer will be a beneficiary of any proceeds payable upon the death of the Shareholder.

<sup>2360</sup> Leimberg and Zaritsky, “IRS Provides New and Substantial Guidance on Employer-Owned Life Insurance,” 36 *Estate Planning*, No. 8, 3 (August 2009).

<sup>2361</sup> Notice 2009-48, A-13 provides:

Section 101(j) does not contain a provision for correcting an inadvertent failure to satisfy the notice and consent requirements of § 101(j)(4). The Service will not, however, challenge the applicability of an exception under § 101(j)(2) based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met: (1) the applicable policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees; (2) the failure to satisfy the requirements was inadvertent; and (3) the failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder in which the employer-owned life insurance contract was issued. Because § 101(j)(4)(B) requires that the employee’s consent be written, failure to obtain such consent cannot be corrected after the insured employee has died.

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

An insurance agent might provide such a consent form, which counsel should consider reviewing, or counsel could provide his/her own consent form to the client. Although some agents understand these issues, many agents do not know (or think they know but actually misunderstand) these rules. Accordingly, tax advisors should consider warning their clients that the tax advisors need to be involved before any policy is issued.

Every applicable policyholder owning one or more employer-owned life insurance contracts issued after August 17, 2006 is required to file IRS Form 8925 each year.<sup>2362</sup> “Applicable policyholder” and “employer-owned life insurance contract” are defined for purposes of this reporting rule the same way they are for determining whether a policy is subject to the notice and consent rules.<sup>2363</sup>

These rules for life insurance contracts issued or materially changed after August 17, 2006.<sup>2364</sup> Notice 2009-48 elaborates on the rules described above, as well as providing rules for what constitutes a material modification,<sup>2365</sup> including guidance on tax-free exchanges.<sup>2366</sup>

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<sup>2362</sup> Code § 6039I(a) is the general reporting requirement, and Reg. § 1.6039I-1 specifies the form.

<sup>2363</sup> Code § 6039I(c).

<sup>2364</sup> P.L. 109-280, Sec. 863(a). Changing a split-dollar agreement without changing the underlying policy will not constitute a material modification under Code § 101(j), although it might very well affect other tax treatment. Notice 2008-42, discussed in part II.Q.4.e.i Split-Dollar Generally, especially the text accompanying fns. 2315-2317.

<sup>2365</sup> Notice 2009-48, A-14 provides:

The following changes are not treated as material changes for purposes of determining whether an existing contract is treated as a new contract for purposes of § 101(j): (1) increases in death benefit that occur as a result of either the operation of § 7702 or the terms of the existing contract (provided the insurer’s consent to the increase is not required); (2) administrative changes; (3) changes from general account to separate account or from separate account to general account; or (4) changes as a result of the exercise of an option or right granted under the contract as originally issued. Thus, for example, a death benefit increase does not cause a contract to be treated as a new contract if the increase is necessary to keep the contract in compliance with § 7702, or if the increase results from the application of policyholder dividends to purchase paid-up additions, or if the increase is the result of market performance or contract design with regard to a variable contract. Notice and consent are required if a contract is treated as a new contract by reason of a material increase in death benefit or other material change, unless a valid consent remains in effect with regard to the insured.

<sup>2366</sup> Notice 2009-48, A-15 provides:

Section 863(d) of the PPA provides that § 101(j) generally does not apply to a contract issued after August 17, 2006 in an exchange described in § 1035 for a contract issued on or before that date. Section 863(d) also provides that, for purposes of determining when a contract is issued, a material increase in the death benefit or other material change generally causes the contract to be treated as a new contract. A § 1035 exchange that results in a material increase in death benefit or other material change (other than a change in issuer) is treated as the issuance of a new contract after August 17, 2006 for purposes of determining whether § 101(j) applies to the contract.



As to buy-sell agreements, Notice 2009-48 provides that a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner – in other words, a cross-purchase - is not subject to these rules.<sup>2367</sup> However, if the business owns it,<sup>2368</sup> the following rules apply (emphasis added):<sup>2369</sup>

### **Exceptions to the Application of § 101(j)(1)**

Section 101(j)(2) provides several exceptions to the application of § 101(j)(1), *provided the notice and consent requirements of § 101(j)(4) are met*. Specifically, under § 101(j)(2)(A), § 101(j)(1) does not apply if the insured either was an employee at any time during the 12-month period before death, or was a director, highly compensated employee or highly compensated individual, as defined, at the time the contract was issued. Under § 101(j)(2)(B), § 101(j)(1) does not apply to any amount received by reason of the death of an insured to the extent the amount is paid to or used to purchase an equity (or capital or profits) interest from a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary, or the estate of the insured.

If plans do change, the Notice allows consent to be given before the death benefit exceeds the amount shown in the consent. The Notice also provides for a change in the employer.

The Notice further provides:

Q-1. Can a contract be an employer-owned life insurance contract if it is owned not by a person engaged in a trade or business, but by a related person who is not engaged in a trade or business?

A-1. No. A contract is an employer-owned life insurance contract only if it is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). Thus, a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner), or by a qualified plan or VEBA that is sponsored by an entity engaged in a trade or business, is not an employer-owned life insurance contract. A contract, however, that is owned by a grantor trust (such as a rabbi trust), assets of which are treated as assets of a grantor that is engaged in a trade or business, is an employer-owned life insurance contract if the contract is otherwise described in § 101(j)(3).

Q-2. Can a contract be an employer-owned life insurance contract if it is subject to a split dollar arrangement?

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<sup>2367</sup> A-1.

<sup>2368</sup> Including through a grantor trust that the business established, per A-1.

<sup>2369</sup> After A-3 and before Q-4.

- A-2. Yes. A contract that is subject to a split dollar arrangement is an employer-owned life insurance contract if the contract is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). See § 1.61-22(c)(1) (defining the owner of a contract subject to a split dollar arrangement to be the person named as the policy owner of the contract). Under § 101(j)(2)(B), however, the general rule of § 101(j)(1) does not apply to the extent any amount received by reason of the death of the insured is paid to a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary.
- Q-3. Is a contract an employer-owned life insurance contract if it is owned by a partnership or sole proprietorship that is engaged in a trade or business; the partnership or sole proprietorship is directly or indirectly a beneficiary under the contract; and, the contract covers the life of an insured who is an employee with respect to the trade or business on the date the contract is issued?
- A-3. Yes. If a life insurance contract is otherwise described in § 101(j)(3), ownership of the contract by a partnership or sole proprietorship does not prevent the contract from being treated as an employer-owned life insurance contract. A life insurance contract that is owned by a sole proprietor on his or her own life is not, however, an employer-owned life insurance contract.
- Q-4. Under § 101(j)(2)(A) and (j)(4), when is a contract treated as “issued” for purposes of determining whether the notice and consent are timely, or whether the insured is a director, a highly compensated employee, or a highly compensated individual at the time the contract is issued?
- A-4. Generally, the issue date of a contract is the date on the policy assigned by the insurance company, which is on or after the date the application was signed. Solely for purposes of § 101(j)(2)(A) and (j)(4), an employer-owned life insurance contract is treated as “issued” on the later of (1) the date of application for coverage, (2) the effective date of coverage, or (3) the formal issuance of the contract. Thus, if an employer-owned life insurance contract is effective for a limited period of time before formal issuance of the contract (such as to complete underwriting), the notice and consent requirements may be satisfied during the period between the effective date of coverage and formal issuance of the contract. In addition, an employer-owned life insurance contract may be treated as a new contract, and thus newly “issued,” by reason of a material increase in death benefit or other material change in the contract. See A-14, this Notice.
- Q-5. For purposes of § 101(j), is the term “employee” limited to common law employees?

A-5. No. Section 101(j)(5)(A) provides that the term “employee” includes an officer, director, and highly compensated employee (within the meaning of § 414(q)). A director is an independent contractor in his or her capacity as a director.

Section 414(q) contains special rules relating to certain former employees and self-employed individuals. For example, a former employee is treated as a highly compensated employee (within the meaning of § 414(q)) if the individual was a highly compensated employee when he separated from service, or was a highly compensated employee at any time after attaining age 55. In addition, the term “employee” for purposes of § 414(q) includes an individual who is a self-employed individual who is treated as an employee pursuant to § 401(c)(1).

Although policies used to fund redemptions are subject to the notice and consent rules if the insured is either an employee or holds at least 5% ownership, an exception applies if and to the extent that the company uses the policy to redeem the insured’s stock shortly after death:

A-6. In order to know whether an amount received as a death benefit under an employer-owned life insurance contract is eligible for exclusion from gross income under § 101(a), or is ineligible for exclusion under the general rule of § 101(j)(1), it is necessary to determine the availability of the exception for amounts used to purchase an equity (or capital or profits) interest in the applicable policyholder. Accordingly, an amount must be so paid or used by the due date, including extensions, of the tax return for the taxable year of the applicable policyholder in which the applicable policyholder is treated as receiving a death benefit under the contract.

I insist on notice and consent - even for redemption arrangements - because the purchase might not be completed within that deadline, the parties might later all agree that the money would be better used in the business, or the death benefit might exceed the purchase price.

If an employee owns a policy at issuance and then transfers it to the employer, then the notice and consent are not required; however, if the employer later increases the face amount of the contract, written notice and consent must be secured to establish the requisite notice to the employee and consent to the new face amount.<sup>2370</sup>

#### **II.Q.4.f.ii. Consent Integrated into Operating Agreement**

As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below. See fn. 2359 for authority for relying on such a provision; however, I recommend obtaining a separate notice and consent for more direct evidence to show the IRS. The rest of this part II.Q.4.f.ii is the sample:

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<sup>2370</sup> Notice 2009-48, A-8.

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

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

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

Notice and Consent

For \_\_\_\_\_ Owner

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

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

- (A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.
- (B) I consent to being insured under these contracts and that such coverage may continue after I no longer own an interest in the Employer or otherwise terminate employment.

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

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

#### **II.Q.4.f.iv. Consent for an Employee**

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

##### Notice and Consent

For \_\_\_\_\_ Employee

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

I acknowledge notification that \_\_\_\_\_ (the “Employer”) intends to obtain a policy insuring my life with a maximum face amount of \$\_\_\_\_\_, and:

- (A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.
- (B) I consent to being insured under these contracts and that such coverage may continue after I terminate employment.
- (C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

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

#### **II.Q.4.g. Establishing Estate Tax Values**

For estate tax purposes, fair market value is defined as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”<sup>2371</sup> If a decedent owns voting and nonvoting shares, the shares are valued together as a single block.<sup>2372</sup>

Regarding buy-sell agreements:<sup>2373</sup>

**(h) Securities subject to an option or contract to purchase.** Another person may hold an option or a contract to purchase securities owned by a decedent at the

<sup>2371</sup> Reg. § 20.2031-1(b). Rev. Rul. 59-60 and its progeny discuss valuation principles.

<sup>2372</sup> *Ahmanson Foundation v. United States*, 674 F.2d 761 (9<sup>th</sup> Cir. 1981).

<sup>2373</sup> Reg. § 20.2031-2(h).

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

Thus, a buy-sell or similar agreement must apply during a decedent's life as well as after death before it might be given effect. Recent cases have reaffirmed this requirement.<sup>2374</sup>

For purposes of gift, estate and GST tax, Code § 2703(a) provides that the value of any property shall be determined without regard to:

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

Thus, when a parent transfers an equity interest to a child pursuant to a legally binding stock option or buy-sell agreement, generally for gift, estate and GST tax purposes the parent is deemed to make a taxable transfer to the extent that the equity interest's value

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<sup>2374</sup> *True v. Commissioner*, 390 F.3d 1210 (10<sup>th</sup> Cir. 2004); *Estate of Blount*, T.C. Memo. 2004-116, *aff'd* in part, *rev'd* in part, 428 F.3d 1338 (11<sup>th</sup> Cir. 2005) (life insurance included in valuing company, but the Eleventh Circuit treated the buy-sell obligation as offsetting the inclusion); *Smith III v. U.S.*, 96 A.F.T.R.2d 2005-6549 (W.D. Pa. 2005). In a case citing *True* but taking an unusual tack, in *Huber v. Commissioner*, T.C. Memo. 2006-96, the IRS tried to use a buy-sell agreement against a taxpayer, but Judge Goeke ruled that a right of first refusal in the agreement did not increase the value of the subject stock. Not mentioned in the Huber opinion is that, according to one of the taxpayer's counsel, prior gift tax audits had accepted the taxpayer's appraisals or settled very close to it, so the IRS' posture was radically different than before. In *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9<sup>th</sup> Cir. 1999), *aff'g* in part and *rev'g* in part T.C. Memo. 1996-286, life insurance proceeds did not increase the value of the decedent's interest in the law firm to which he had belonged, except as necessary to take into account advanced client costs and work in process pursuant to the buy-sell agreement.

exceeds the payment under that agreement. These rules extend to all sorts of arrangements.<sup>2375</sup>

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

A waiver of the right to partition art was disregarded under Code § 2703(a)(2).<sup>2376</sup>

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

(1) It is a bona fide business arrangement.<sup>2377</sup>

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<sup>2375</sup> Reg. § 25.2703-1(a)(3).

<sup>2376</sup> *Elkins v. Commissioner*, 140 T.C. No. 5 (2013).

<sup>2377</sup> *Holman v. Commissioner*, 130 T.C. 170 (2008) held:

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

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

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

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

Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no “business,” active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that “maintenance of family ownership and control of [a] business” may be a bona fide business purpose. *St. Louis County Bank*, 674 F.2d at 1207; see also *Estate of Bischoff v. Commissioner*, 69 T.C. 32, 39–40 (1977). We have not so held, however, in the absence of a business. [footnote described below]

That is not to say we necessarily believe it will always be easy to apply § 2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult. See, e.g., *Higgins v. Commissioner*,

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312 U.S. 212, 217–18 (1941) (holding in another context that merely keeping records and collecting interest and dividends did not amount to “carrying on a business”); *Estate of Thompson v. Commissioner*, 382 F.3d 367, 380 (3d Cir. 2004) (“Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations.”).

In footnote 3 discussing the *St. Louis County Bank* case, 674 F.2d 1207 (8<sup>th</sup> Cir. 1982), the court pointed out:

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

Judge Beam offered a strong dissent:

Here, the Tax Court made the express factual determination that the partnership agreement restrictions were “designed principally” to protect family assets from dissipation by the Holman daughters. *Holman*, 130 T.C. at 195 (emphasis added). In other words, the Tax Court determined that the restrictions were designed primarily to serve a non-tax purpose. Notably, the Tax Court did not find that the Holmans merely paid lip service to legitimate business purposes for the restrictions while, in reality, using the restrictions for the primary purpose of avoiding taxes. [footnote omitted] Additionally, the Tax Court did not find that the restrictions failed to match the partnership’s legitimate, non-tax goals. [footnote omitted] The underlying purposes of § 2703 are not served where, as here, the bona fide business arrangement test is applied in a manner that discourages partners in family partnerships from creating restrictions principally to achieve non-tax, economic goals. Thus, I would hold that the Holman partnership agreement restrictions are “bona fide business arrangements” because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership’s investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners’ fundamental right to choose who may become a partner....

Having determined that the partnership restrictions satisfy § 2703(b)(1), I now turn to § 2703(b)(2)’s “device” test. Under this test, the Holman partnership restrictions must not be a “device to transfer such property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth.” I.R.C. § 2703(b)(2) (emphasis added). Treasury Regulation § 25.2703-1(b)(1)(ii) excises the phrase “members of the decedent’s family” found in § 2703(b)(2) and substitutes in its place the phrase “natural objects of the transferor’s bounty,” apparently because the Secretary of the Treasury interprets § 2703(b)(2) to apply to both inter vivos transfers and transfers at death. *Holman*, 130 T.C. at 195–96. Applying this regulation, the Tax Court held that the Holman partnership restrictions operate as a device to transfer property to the natural objects of the Holmans’ bounty. The Holmans argue that Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it fails to give effect to § 2703(b)(2)’s plain language. I agree. [discusses Chevron deference] The parties primarily dispute whether § 2703(b)(2) is ambiguous. The Holmans assert that the term “decedent” unambiguously refers to a deceased person and, therefore, § 2703(b)(2) asks only whether restrictions operate as a device to transfer property to family members at death. The Holmans point out that only the term “decedent,” not the broader term “transferor,” is used throughout § 2703(b)(2)’s legislative history. Conversely, the Commissioner argues that the term “decedent” is ambiguous due to § 2703’s location in the Internal Revenue Code. Specifically, § 2703 is located in Subtitle B of the Code, which includes three transfer taxes—the estate, gift and generation-skipping transfer taxes. More precisely, § 2703 is located in Subtitle B, Chapter 14. In Chapter 14, § 2703 joins a set of special valuation rules targeting



- (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
- (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

One way to satisfy this exception is if the entity is not family owned, using Code § 2701 principles.<sup>2378</sup>

A right or restriction is considered to meet each of the three requirements ... if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described

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transfer tax avoidance schemes. It is clear that the phrase "members of the decedent's family" unambiguously limits § 2703(b)(2)'s application to transfers at death. First, the term "decedent" is itself unambiguous. *Black's Law Dictionary* 465 (9<sup>th</sup> ed. 2009) plainly defines "decedent" as "[a] dead person." Moreover, the phrase "members of decedent's family" is not ambiguous when read in the greater context of Chapter 14. While Congress used the term "decedent" in § 2703(b)(2), it used the broader term "transferor" in Chapter 14's other valuation statutes. See I.R.C. §§ 2701(a)(1) & 2702(a)(1). And, as the Holmans point out, the term "decedent" consistently appears in § 2703(b)(2)'s legislative history. Finally, I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase "members of the decedent's family" with the Commissioner's phrase "natural objects of the transferor's bounty." See *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at 6 n.3 (W.D. Pa. June 30, 2004). Thus, although Congress enacted Chapter 14 to generally address transfer tax avoidance schemes, § 2703(b)(2) applies specifically to transfers at death. Therefore, Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it does not give effect to the plain language of § 2703(b)(2). Since the Holmans are living persons, they are, by definition, not "decedents" and § 2703(b)(2)'s device test is satisfied.

...Under § 2703(b)(3)'s "comparable terms" test, the Holman partnership restrictions' terms must be "comparable to similar arrangements entered into by persons in an arms' length transaction." While the Tax Court did not decide whether the restrictions satisfied the comparable terms test, it noted that both parties' experts "agree that transfer restrictions comparable to those found in [the Holman partnership agreement] are common in agreements entered into at arm's length." [footnote omitted] *Holman*, 130 T.C. at 198-99. The Tax Court explained that this "would seem to be all that [the Holmans] need to show to satisfy section 2703(b)(3)." *Id.* at 199. I agree, and I would hold that the Holman partnership restrictions satisfy § 2703(b)(3)'s comparable terms test. Thus, because the partnership restrictions satisfy all three of § 2703(b)'s tests, I would reverse and remand to the Tax Court for a valuation of the limited partnership interests that does not disregard the partnership restrictions.

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

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

<sup>2378</sup> Reg. § 25.2703-1(b)(3).

in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

If the entity does not satisfy this non-family-controlled test, then one must satisfy each of the above three exceptions separately. The Code § 2703(b)(3) comparability test, which is the main test that Code § 2703 added to pre-1990 law, uses the following principles:<sup>2379</sup>

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

The Tax Court, convinced that the taxpayer's buy-sell agreement was arrived upon in a manner intended to arrive at fair market value, applied the comparability test in *Estate of Amlie*:<sup>2380</sup>

For the reasons discussed below, we conclude that the estate has satisfied section 2703(b)(3). By its terms, the statute requires only a showing that the agreement's terms are "comparable" to similar arrangements entered at arm's length. While the regulations caution against using "isolated comparables", we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.

Even if the above rules are not complied with, obligations do tend to affect a stock's marketability,<sup>2381</sup> in that they cloud the business' future operations.<sup>2382</sup>

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<sup>2379</sup> Reg. § 25.2703-1(b)(4).

<sup>2380</sup> T.C. Memo. 2006-76.

Keeping a pre-1990 agreement outside of the application of Code § 2703 would avoid the statute's imposition of the comparability test. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in a significant change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification that's would subject it to this test.<sup>2383</sup> If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless updating would not have resulted in a substantial modification.<sup>2384</sup> Adding any family member as a party to a right or restriction is a substantial modification unless either the terms of the right or restriction require the addition or the added family member is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction.<sup>2385</sup> However, a substantial modification does not include a modification required by the terms of a right or restriction, a discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction, a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate, or a modification that results in an option price that more closely approximates fair market value.<sup>2386</sup> Amending an agreement to extend the number of years of payment, to clarify that the prime rate is to be established semi-annually, and to update the name of the banking institution from the original bank's name to its successor's name was not a substantial modification.<sup>2387</sup> Issuing nonvoting shares proportionately to the owners of voting stock in an S corporation was not a substantial modification.<sup>2388</sup>

Finally, many of the buy-sell restrictions in partnership agreements are no more restrictive than would otherwise apply under state law, so the application of Code § 2703 would not have a significant impact on the valuation. Yet the IRS makes a big deal of

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<sup>2381</sup> Rev. Rul. 77-287 explains valuation adjustments due to stock being restricted from resale pursuant to Federal securities laws.

<sup>2382</sup> *True v. Commissioner*, 390 F.3d 1210 (10<sup>th</sup> Cir. 2004), citing *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, for the concept that, even if a provision does not bind the IRS as to estate tax value, it can still affect its value; *Estate of Blount*, 428 F.3d 1338 (11<sup>th</sup> Cir. 2005), *rev'g* T.C. Memo. 2004-116.

<sup>2383</sup> Reg. § 25.2703-1(c)(1).

<sup>2384</sup> Reg. § 25.2703-1(c)(1).

<sup>2385</sup> Reg. § 25.2703-1(c)(1).

<sup>2386</sup> Reg. § 25.2703-1(c)(2).

<sup>2387</sup> Letter Ruling 201313001.

<sup>2388</sup> Letter Ruling 201536009, reasoning:

In this case, the stock split and amendment to the Articles will apply to all of the common shares (whether voting or nonvoting). Because each shareholder will receive c shares for every common share he or she currently holds, the beneficial interests in Company will not be affected by the stock split, amendment, and share dividend.

Likewise, because the number of authorized voting shares will continue to be x, the shareholders' voting rights will remain unchanged.

Consequently, the stock split, amendment to the Articles, and share dividend will not affect the quality, value or timing of any rights under the Articles, and the changes will not be a substantial modification of the Articles for purposes of § 25.2703-1(c). Accordingly, the Articles will remain exempt from the application of chapter 14.

these issues on audit and acts as if some of the cases cited above give it a major advantage. Consider asking the appraiser to expressly state that (s)he is ignoring any provisions in the agreement that are more restrictive than otherwise applicable state law. That way, when the IRS makes a big deal about Code § 2703, one might respond that one has already assumed that Code § 2703 applied, so that issue is off the table.

#### **II.Q.4.h. 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,<sup>2389</sup> 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.h.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 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

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<sup>2389</sup> See text accompanying fns. 2263-2265 regarding certain transfers involving partnerships.

receive the right to death benefits from Policies on Sister's and BA's lives in proportion to the premiums that Brother and Brother's Irrevocable Trust made these premium contributions. The goal was to maximize Brother's Irrevocable Trust's proportion of contributions, because Brother's Irrevocable Trust and any trusts created under it are excluded from the estate tax system. However, given the uncertainties of cash flow and the impracticality of frequently changing beneficiary designations, being flexible in sharing premiums was important and the LLC's use of partnership accounting seemed to be the best way to accomplish that. Brother and Sister had virtually identical goals regarding the buy-sell arrangement.

The LLC had some other features. The manager was a corporate trustee. Using a corporate trustee as manager provided security to ensure that no party to the buy-sell agreement would use the life insurance proceeds improperly. The manager was instructed to retain all life insurance proceeds until the parties agreed on their application toward the cross-purchase. Thus, the manager's roles were essentially the equivalent of a combination of trustee of an irrevocable life insurance trust before a shareholder's death and escrow agent for the buy-sell agreement after a shareholder's death.

The LLC's activity required special partnership accounting provisions. Each member had a separate capital account for each policy the member owned on a shareholder. Also, the members needed to contribute cash to pay the LLC's administrative expenses, requiring an additional set of capital accounts.

#### **II.Q.4.h.ii. Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity**

Code § 2042 provides that a decedent's gross estate includes insurance proceeds from a policy on a decedent's life if the decedent, at his or her death, possessed any incidents of ownership over such policy, exercisable either alone or in conjunction with any other person.<sup>2390</sup> The term "incidents of ownership" includes more than ownership of the policy in the technical legal sense. Generally, it refers to the right of the insured or the insured's estate to the economic benefits of the policy. It also includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke

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<sup>2390</sup> 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 (under Code § 672(c) – see fn. 1180) the grantor when the two designated trustees are unavailable to act as trustee or are removed; however, the grounds for removal were not spelled out. The IRS pointed out that Reg. § 20.2042-1(c)(4) provides that:

A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The IRS looked to Rev. Rul. 77-182 (no Code § 2036 inclusion where decedent could appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process) and 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 (under Code § 672(c) – see fn. 1180).

an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy. If Code § 2042 applies, then generally the decedent must include all of the insurance proceeds in his or her gross estate.

Simple cross-purchase agreements avoid these issues. Rev. Rul. 56-397 ruled that when each of two business associates owns, is the beneficiary of and pays all premiums for an insurance policy on the other business associate, neither of the business associates possesses incidents of ownership in the policy on his or her respective life.

#### **II.Q.4.h.ii.(a). Trust Ownership of Policy**

Reg. § 20.2042-1(c)(4) provides, “A decedent is considered to have an ‘incident of ownership’ in an insurance policy on his life held in trust if, under the terms of the policy, the decedent...has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.” Does being the trustee of a trust containing an insurance policy on the trustee’s life, with the trustee having no beneficial interest in the trust, result in estate tax inclusion under Code § 2042? The *Skifter* case<sup>2391</sup> 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.*<sup>2392</sup> held that there was no transfer requirement. 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

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<sup>2391</sup> 468 F.2d 699 (2<sup>nd</sup> Cir. 1972).

<sup>2392</sup> 511 F.2d 259 (5<sup>th</sup> Cir. 1975).

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.

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.<sup>2393</sup>

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

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<sup>2393</sup> *Estate of Rockwell v. Commissioner*, 779 F.2d 931 (3<sup>rd</sup> Cir. 1985).

Code § 2042(2).<sup>2394</sup> This conclusion was based on the view that dividends represent a return of premiums<sup>2395</sup> and did not address whether dividends in excess of premiums would be treated differently.

#### **II.Q.4.h.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.h.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.<sup>2396</sup> Rev. Rul. 83-147 held that a partner does possess incidents of ownership if the policy on the partner's life is owned by the partnership, designates a member of the partner's family as the beneficiary, and premiums were paid by the partnership in partial satisfaction of the partner's share of partnership income. The ruling stated that the result was different than the Tax Court case because the beneficiary was not the partnership.

In a number of Letter Rulings, the IRS has addressed Code § 2042 with respect to a partnership that owns and is designated as the beneficiary of an insurance policy on the life of one of its partners.

Letter Ruling 9623024 held that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement states that the proceeds, once received by the partnership, can be distributed to the remaining partners in proportion to their interests to the extent that the proceeds from the policy were not needed to pay the partnership's obligations. The IRS reasoned that the value of the deceased partner's interest would include his pro rata portion of the proceeds and therefore inclusion under Code § 2042 would amount to unwarranted double counting of the proceeds.

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<sup>2394</sup> CCA 201328030.

<sup>2395</sup> 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).

<sup>2396</sup> *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 (4<sup>th</sup> Cir.), *cert. denied*, 355 U.S. 827 (1957).



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."<sup>2397</sup>

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.h.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

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<sup>2397</sup> I 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.

that the operating agreement not expressly authorize amendments by the members, preferring that applicable state law defaults control the situation.

The ruling did not address the effect of the members' assigning their interests in the LLC to others. Although the IRS was not troubled by the prospect of that occurring, it did not wish to consider situations that might arise by reason of such an assignment.

An issue with respect to with a ruling was not sought is the transfer-for-value rules, which make death benefits taxable if policies are transferred in various taxable transactions.<sup>2398</sup> Formation of the LLC should not implicate these rules, because formation is a nontaxable transfer.<sup>2399</sup> Similarly, a Member receiving an increased ownership percentage of a policy due to an increased contribution is also a nontaxable transfer.<sup>2400</sup> 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.<sup>2401</sup>

#### **II.Q.4.h.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.<sup>2402</sup> 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.

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<sup>2398</sup> Code § 101(a)(2).

<sup>2399</sup> Code §§ 101(a)(2)(A), 721(a).

<sup>2400</sup> Code § 721(a).

<sup>2401</sup> Code § 101(a)(2)(B).

<sup>2402</sup> See footnote 2243 for a summary of how split-dollar arrangements work.

The ruling also held that Brother's Irrevocable Trust was a grantor trust, in which Brother was treated as owning Brother's Irrevocable Trust's assets for income tax purposes under Code § 678; Sister was similarly treated as the owner of Sister's Irrevocable Trust. This was critically important to allow Brother's Irrevocable Trust and Sister's Irrevocable Trust to own stock in the S corporation. Brother initially had a withdrawal right in Brother's Irrevocable Trust that had since lapsed; the same tool was used for Sister and Sister's Irrevocable Trust. Although such withdrawal rights are usually used to obtain the gift tax annual exclusion, in this case a significant purpose of granting withdrawal rights was to obtain grantor trust status treating the beneficiary as the owner. Based on more recent informal conversations with a representative of the government, my understanding is that, although the IRS has no plans to change its approach toward Code Sec. 678 when it issues Letter Rulings, it also has no plans to issue a formal pronouncement upon which taxpayers can generally rely.

The above issues are as far as was the ruling was sought to cover. However, this structure has uses far beyond the issues discussed in the ruling.

First, Trusts 2A and 2B were originally funded with modest gifts that they invested in LLCs that used bank financing to buy real estate. These LLCs leased the real estate to the S corporation. 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.<sup>2403</sup> 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,

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<sup>2403</sup> See part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts.

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.h.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.f 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.f.iii Consent for Owner Who Is Not an Employee. However, the operating agreement might also include notice and consent as a safety valve.<sup>2404</sup>

Often, the operating business will pay the premiums on behalf of the owners – just to make sure it gets done so that the business' succession plan is funded as expected.

If the operating business is a C corporation, it would account for the premium payments as compensation (as an officer or director), because dividends are nondeductible to the company and taxable to the shareholders.

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.<sup>2405</sup>

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.

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<sup>2404</sup> See fn. fn. 2359, which is found in part II.Q.4.f.i Analysis of Code § 101(j); for an example, see part II.Q.4.f.ii Consent Integrated into Operating Agreement.

<sup>2405</sup> See part II.A.2.i.ii Temporary Timing Differences.

#### **II.Q.4.h.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.<sup>2406</sup> 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.h.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.d 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,<sup>2407</sup> consider whether this new basis increases the "investment in the contract" and, if not, whether additional steps should be taken to effectuate that increase.<sup>2408</sup>

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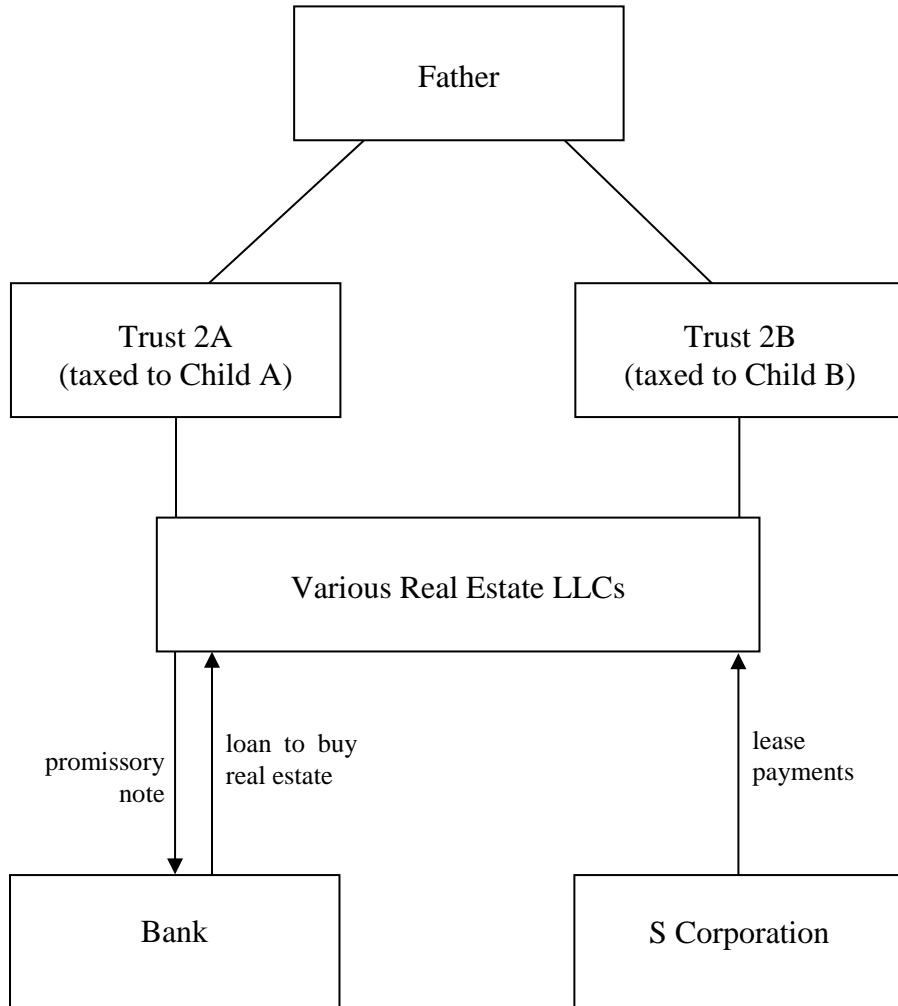
<sup>2406</sup> See also Letter Rulings 200948001 and 200949004, which appear to be companion rulings.

<sup>2407</sup> 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.d.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured.

<sup>2408</sup> See part II.Q.4.d.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured.

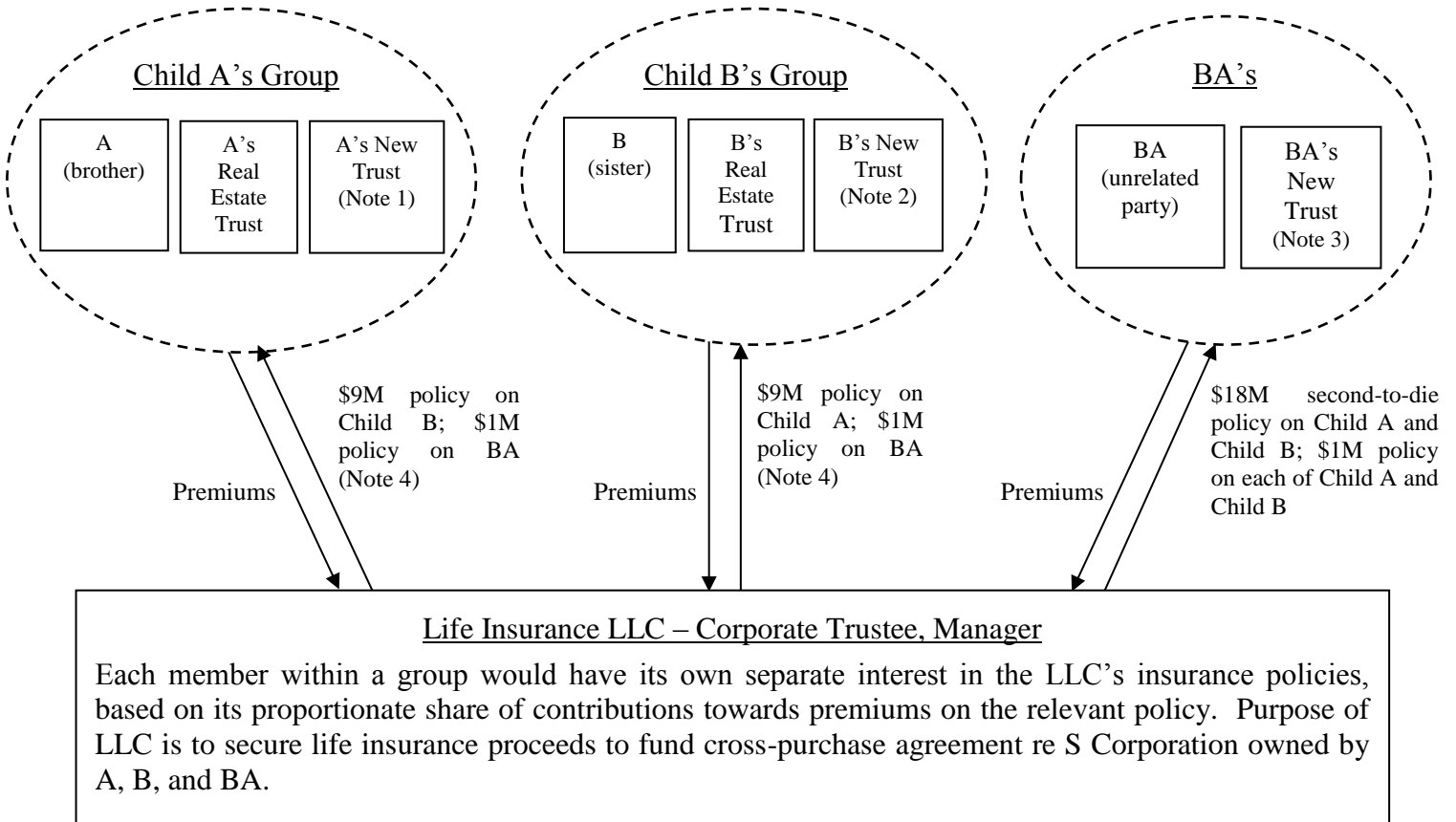
**Appendix A**

**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**

