Estate & Succession Planning Corner

By Lawrence I. Richman

Rev. Rul. 2007-13 Provides Clarity on The Transfer for Value Rule and Outlines How to Avoid the Three-Year Estate Inclusion Rule of Code Sec. 2035

In February, 2007, the IRS issued Rev. Rul. 2007-13,[1] which held that a grantor will be treated as the owner of a life insurance policy on the grantor's life when the policy is owned by a grantor trust of which the grantor is treated as owner. This ruling came after several years of private letter rulings in which the government had led taxpayers to believe that an insured would be treated as the owner of a life insurance policy for purposes of Code Sec. 101, if that policy were owned by an irrevocable trust taxable to the grantor under the grantor trust rules of subchapter J of the Code.[2]

In Rev. Rul. 2007-13,[3] the IRS posited two factual situations involving grantor trusts. The facts do not state how these trusts came to be treated as grantor trusts nor do the facts state whether the trusts were irrevocable. The first fact pattern involved two grantor trusts, each of which was treated as being wholly owned by the grantor under subchapter J of the Code. The second grantor trust owned a life insurance policy on the life of the grantor. The second grantor trust then transferred the life insurance policy to the first grantor trust in exchange for cash.

The second factual situation addressed in the revenue ruling also involved two trusts. The factual difference in the second fact pattern was that the second trust was not a grantor trust. In that second fact pattern, the nongrantor trust transferred a life insurance policy to a grantor trust in exchange for cash.

In analyzing the two factual situations, the IRS first addressed the definition of what constitutes a transfer for value and specifically how the exclusion from gross income rules of Code Sec. 101(a)(1) do not apply when a life insurance contract is transferred

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for a valuable consideration unless the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer. The IRS then analyzed Rev. Rul. 85-13[4] and noted how in that revenue ruling the IRS had determined that when a grantor is treated as the owner of a trust, the grantor is deemed the owner of the assets of the trust for federal income tax purposes.

The fact that the grantor of a grantor trust is treated as the owner not only of the trust, but also of the assets of the trust for federal income tax purposes, led the IRS to conclude that in the first situation, in which the transfer was between two grantor trusts, that the grantor was to be treated as the owner of both the insurance policy owned by the second grantor trust and the cash owned by the first grantor trust. Accordingly, the IRS determined that because the insured was merely transferring the policy to him/herself the transfer for value rules did not apply because there had been no transfer of the life insurance policy within the meaning of Code Sec. 101(a)(2).

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In the second situation, the grantor was treated as being the owner of all of the assets of the trust that owned the cash (the first trust) and not as the owner of the assets of the second trust that owned the life insurance policy (which under the facts was not a grantor trust). After the exchange of the life insurance policy for the cash in the second situation, the grantor was treated as being the owner of the life insurance policy. Accordingly, there was a transfer of a life insurance policy for a valuable consideration within the meaning of Code Sec. 101(a)(2), but the exception to the transfer for value rules applied because the transfer to the grantor trust was deemed to be a transfer to the insured and a transfer to the insured is one of the exceptions to the transfer for value rule. Thus, in the second situation, the proceeds of the life insurance policy would not be included in gross income on the death of the insured.

While the ruling sounds like good news and it is, there are several gaps. The first is what consequence, if any, is there upon termination of grantor trust status. The termination of grantor trust status is often viewed as a deemed transfer of the trust estate to the now irrevocable trust for income tax purposes. In the instant situation, one unanswered question is: if the grantor trust acquired the insurance policy for a note and the note is outstanding at death, does a transfer for value occur upon termination of grantor trust status. Worse yet, what if the trust's basis in the policy is less than the value of the note. The *Madorin*[5] case is authority for the proposition that upon termination of grantor trust status an irrevocable trust will recognize gain to the extent debt exceeds a trust's basis in its assets. Depending when one determines basis, the so-called "negative basis" issue may disappear at such time as the trust becomes entitled to receive the life insurance proceeds upon the death of the insured.

Notwithstanding gaps in the scope of the ruling, its importance in clarifying the transfer-for-value rule under Code Sec. 101(a)(2), which causes insurance proceeds to lose their income tax excluded character, should not be underestimated because if a transfer for value were found to have been made, upon receipt of the proceeds of the life insurance policy only the amount equal to the consideration paid would be excluded from gross income.

By clarifying rules involving transfers for consideration, the IRS enables taxpayers to consider circumstances in which transfers for consideration are exceptions to rules taxpayers would otherwise like to avoid. Prominent among those rules with respect to transfers of life insurance is Code Sec. 2035, which provides:

> (a) Inclusion of Certain Property in Gross Estate. –If-
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> (i) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
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> (ii) the value of such property (or an interest therein) would have been included in the decedent's gross estate under Section 2036, 2037, 2038 or 2042 if such transferred interest or relinquished power had been retained by the decedent on the

date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

It is the exception, however, to the three-year estate inclusion rule for "any bona fide sale for an adequate and full consideration in money or money's worth"[6] that is of particular importance in light of Rev. Rul. 2007-13.

While the ruling provides guidance on the subject of consideration, it is silent on the matter of valuation: namely, what dollar amount constitutes adequate and full consideration when a life insurance policy is transferred.

The valuation issue under Code Sec. 2035 has a tortured, albeit somewhat dated, history. While practitioners most commonly use the interpolated terminal reserve value plus the amount of the unearned premium for the determination of the transfer tax value of a life insurance policy, the IRS has in the past taken a different approach in determining the definition of adequate and full consideration for the transfer of a life insurance policy under Code Sec. 2035.

Almost 20 years ago in TAM 8806004,[7] the IRS came to the bizarre conclusion that for purposes of Code Sec. 2035 there will be adequate consideration in a transfer of an insurance policy only if the amount paid equals the death benefit of the policy. While some planners thought there might be an arbitrage opportunity in what appeared to be differing valuation formulas for gift and estate purposes, the reality was that the approach taken by the IRS created a great deal of planning and valuation uncertainty. Case law did not ease the level of uncertainty in that courts recognized that the state of health of the insured causes there to be an investment element in a life insurance policy in excess of its interpolated terminal reserve or cash surrender value.[8]

For situations in which an insured is in good health at the time of the transfer (regardless of whether death occurs within the three-year statutory period of Code Sec. 2035), it would seem reasonable that the valuation rules applicable to gifts of insurance policies as explained in Reg. §25.2512-6(a) should apply. This rule states that the "…valuation of an insurance policy …which has been in force for some time and on which further premium payments are to be made . . . 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."

Where then does the practitioner go from here? There are, it seems, several precepts one can follow from Rev. Rul. 2007-13.

1. An individual in good health can avoid the three-year rule of 2035 by selling an existing life insurance policy to an irrevocable grantor trust.
2. An individual in good health can cure a "bad" insurance trust and avoid the three-year rule, if the trustee sells an existing life insurance policy to an irrevocable grantor trust taxable to the insured grantor.
3. Cash is the preferred form of consideration. If a promissory note is used, the note should be paid in full prior to the death of the insured.
4. For individuals in good health, the life insurance policy may be valued by determining its interpolated terminal reserve value and then adding to that value the amount of the unearned premium.

Given the potentially significant estate tax cost if an insured dies within three years of the transfer of an existing life insurance policy to an irrevocable insurance trust, following the above precepts can be a tax efficient way of avoiding that estate tax exposure.

Endnotes

1 Rev. Rul. 2007-13, IRB 2007-11, 684.

2 *See, e.g.*, LTRs 200228019 (Apr. 10, 2002), 200247006 (Aug. 9, 2002), 200514001 (Dec. 13, 2004), 200514002 (Dec. 13, 2004), 200518061 (Jan. 14, 2005), 200606027 (Nov. 9, 2005) and 200636086 (May 30, 2006).

3 Rev. Rul. 2007-13, IRB 2007-11, 684.

4 Rev. Rul. 85-13, 1985-1 CB 184, which held that a transaction between a grantor and a grantor trust of which the grantor is treated as owner is ignored for income tax purposes.

5 *B. Madorin*, 84 TC 667, Dec. 42,023.

6 Code Sec. 2035(d).

7 TAM 8806004 (Nov. 4, 1987).

8 *See, e.g., M.H. Pritchard*, 3 TCM 1125, Dec. 14,205(M) (1944).