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Sidestepping 2035

How to structure the sale of a life insurance policy to an irrevocable grantor trust to avoid the three-year estate inclusion rule

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It's been a stable of estate planning for many years to have an irrevocable life insurance trust own life insurance. But advisors are careful to warn clients that if they transfer an existing policy to such a trust and die within three years of that transfer, Internal Revenue Code Section 2035 will apply. This section provides that "the value of such property (or an interest therein) would have been included in the decedent's gross estate under Sections 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."[1]

There is an exception to the three-year estate inclusion rule for "any bona fide sale for an adequate and full consideration in money or money's worth." Despite this exception, estate planners often view both the insured's sale of a life insurance policy to an irrevocable insurance trust established by the insured, and the sale by an existing irrevocable insurance trust to a new irrevocable insurance trust, as complicated transactions for which the Internal Revenue Service has given insufficient guidance regarding two key tax issues.

First is the gift/estate tax matter of valuation. What constitutes adequate and full consideration when a life insurance policy is transferred? The second issue is the income tax one of the transfer-for-value rules of IRC Section 101, which, if triggered, eliminates the income exclusion for insurance proceeds.

The valuation issue under IRC Section 2035 has a tortured history. While practitioners commonly use the interpolated terminal reserve value plus the amount of the unearned premium to determine the transfer tax value of a life insurance policy, the IRS has taken a different approach in determining the definition of adequate and full consideration for the transfer of a life insurance policy under Section 2035.

Almost 20 years ago, in Technical Advice Memorandum 8806004, the IRS came to the bizarre conclusion that, for purposes of Section 2035, there will be adequate consideration in a transfer of an insurance policy only if the amount paid equals the policy's death benefit. 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 IRS' approach created a great deal of uncertainty in planning and valuation. Case law did not alleviate this uncertainty, because courts recognized that the insured's state of health creates an investment element in a life insurance policy in excess of its interpolated terminal reserve or cash surrender value.[2]

> Planners have been wary of the insured's selling a life insurance policy to an irrevocable insurance trust he established.

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 Section 2035), it would seem reasonable that the valuation rules applicable to gifts of insurance policies as explained in Treasury Regulations Section 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."

The second tax issue that led planners to hesitate before proceeding with a sale of a life insurance policy is the transfer-for-value rule under Section 101(a)(2), which causes insurance proceeds to lose their income tax excluded character if a transfer for value is found to have been made. If such a transfer for value were to occur, then—upon receipt of the proceeds of the life insurance policy—only the amount equal to the consideration paid would be excluded from gross income.

In February 2007, the IRS issued Revenue Ruling 2007-13, 2007-11 IRB, holding that a grantor will be treated as the owner of a life insurance policy on his 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 Section 101 if that policy were owned by an irrevocable trust taxable to the grantor under the grantor trust rules of subchapter J of the IRC.[3]

Interestingly, in Revenue Procedure 2007-3,[4] the IRS had stated that it would not issue advance rulings on whether there was a transfer for value in situations involving a grantor and an insurance trust.[5] The IRS also had stated it would not rule on the circumstances that cause an irrevocable insurance trust to be considered a grantor trust for income tax purposes.[6]

In Rev. Rul. 2007-13, the IRS posited two factual situations involving grantor trusts. The facts don't state how these trusts came to be treated as grantor trusts nor whether the trusts were irrevocable:

(1) The first fact pattern involved two

grantor trusts each of which was treated as being wholly owned by the grantor under IRC subchapter J. The second grantor trust owned a life insurance policy upon the life of the grantor. This trust then transferred the life insurance policy to the first grantor trust in exchange for cash.

(2) The second fact pattern also involved two trusts. The only difference from the first fact pattern was that in this second example, the second trust was not a grantor trust. In this second fact pattern, the nongrantor trust transferred a life insurance policy to a grantor trust in exchange for cash.

In analyzing the two fact situations, the IRS first addressed the definition of what constitutes a transfer for value and specifically, how the exclusion from the gross income rules of IRC Section 101(a)(1) does not apply when a life insurance contract is transferred 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[7] and noted how in that revenue ruling, it 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, 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 herself, the transfer-for-value rules did not apply, as there had been no transfer of the life insurance policy within the meaning of IRC Section 101(a)(2).

In the second situation, the grantor was treated as the owner of all the assets of the first trust, which owned the cash but not as the owner of the second, nongrantor trust's assets, which owned the life insurance. In the second situation, after the exchange of the life insurance policy for the cash, the grantor was treated as the owner of the life insurance policy. Accordingly, there was a transfer of a life insurance policy for valuable consideration within the meaning of IRC Section 101(a)(2). But here 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 were not to be included in gross income on the death of the insured.

While the ruling sounds like good news—and it is—there are several unanswered questions. The first: 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 this situation, one unanswered question is, if the grantor trust acquired the insurance policy for a note and the note is outstanding at death, would 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*[8] case is the leading authority for the proposition that, upon termination of grantor trust status, an irrevocable trust recognizes gain to the extent debt exceeds a trust's basis in its assets. Depending on 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.

Where do advisors go from here? It does seem that Revenue Ruling 2007-13 offers several precepts to follow.

So where do practitioners 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 Section 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 insured's death.

(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 these principles can be a tax efficient way of avoiding that estate tax exposure. ∎

Endnotes

1. Internal Revenue Code Section 2035(a).
2. *See, for example*, *Pritchard v. Commissioner*, 3 TCM 1125 (1944).
3. *See, for example*, Private Letter Rulings 200228019, 200247006, 200514001, 200514002, 200518061, 200606027 and 200636086.
4. Revenue Procedure 2007-3, 2007-1 I.R.B. 108.
5. *Ibid.*, at Section 3.01(7).
6. *Ibid.*, at Section 3.01 (47).
7. Revenue Ruling 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 the owner, is ignored for income tax purposes.

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