

# Estate Planning Review

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## IRS ANSWERS TRUST TRANSFER FOR VALUE QUESTION

### Transfer for Value, In General

**CCH:** Could you provide our readers with a preliminary overview of the Code Sec. 101 rules governing transfer-for-value?

**Dr. Slavutin:** Generally, transfer for value refers to the transfer of a life insurance policy from one individual or entity to another in exchange for something of value. For

*For the first time in a published revenue ruling the IRS has answered an important question concerning the impact of the transfer-for-value rules on the transfer of a life insurance policy from one trust to another. Prior to the ruling, the IRS had only addressed this issue in private letter rulings. To provide his insights on the transfer-for-value rules generally and on the reasoning and ramifications of this revenue ruling, we turn to Lee Slavutin, MD, CLU, who is a principal of Stern Slavutin-2 Inc., an insurance and estate planning firm in New York City, and a member of the CCH Financial and Estate Planning Advisory Board.*

example, if I own a life insurance policy on my life and I sell it to you for a sum of money, that is a transfer for value. Consequently, when I die, the life insurance proceeds that you receive will no longer be entitled to income tax-free treatment. Instead, the death benefit will be taxable to the extent it exceeds your basis in the policy for income tax purposes. Ordinarily, your

basis consists of the amount you paid for the policy when you bought it from me, plus any premiums paid after that.

**CCH:** Could you elaborate on exactly how one is expected to compute basis in a life insurance policy?

**Dr. Slavutin:** The IRS, in two private letter rulings (IRS Letter Ruling 9443020 and CCA Letter Ruling 200504001), has said that basis should be decreased by the cost of insurance for each year the policy is owned. The cost of insurance is typically the value of the term

insurance protection, such as the P.S. 58 (now Table 2001) amount used in connection with split-dollar insurance, or some comparable measure of the value of the insurance protection each year. Accordingly, if I had a \$1 million whole life policy for which I was paying \$10,000 per year in premiums, and the value of the term insurance protection for one year was \$1,000, the IRS would say that my increase in basis for the year was not the value of the premium payment, but the premium payment of \$10,000, minus the \$1,000 cost of insurance.

Many commentators believe that the position of the IRS on this point is incorrect and that the principles of Code Sec. 72 dictate that only the premiums paid should figure into this equation. However, I think it is important for practitioners to be aware that there is a question as to exactly how basis is determined.

**CCH:** In order to run afoul of the rules concerning transfer-for-value, is it necessary to transfer the entire interest in a life insurance policy?

**Dr. Slavutin:** No, it could be triggered by a partial transfer. For example, designating someone as an irrevocable beneficiary of a life insurance policy in return for the receipt of some form of consideration would come under the rule. The words "transfer" and "value" have a broad meaning in the context of this rule. For this reason,

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any practitioner with a client who is contemplating the transfer, assignment of rights, or change in ownership of an insurance policy should very carefully review the transfer-for-value rules to assure that they are not going to be caught by them. Losing the tax-free status of the death benefit of a life insurance policy is one of the worst disasters that can befall an advisor and it could potentially expose him or her to liability for failing to anticipate and avoid the problem.

**CCH:** Under Code Sec. 101(a)(2), there are also a number of exceptions to the transfer-for-value rule. Could you describe them for us?

**Dr. Slavutin:** These exceptions fall into two groups. The first group is based on the identity of the recipient of the policy. This group of exceptions covers a transfer to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation of which the insured is a shareholder or officer. The second group involves cases in which there is a carryover of basis from the transferor to the transferee. The best example of that is a transfer of a policy by gift. I would like to point out that there are three notable omissions from this list of exceptions. Unlike a transfer to a partner, there is no exception for a transfer to a co-shareholder. There is also no mention of a grantor trust, nor is there a mention of a limited liability company (LLC) in these exceptions, even though an LLC is very similar to a partnership for tax purposes.

### Revenue Ruling 2007-13

**CCH:** Now that you have laid the groundwork, could you describe the facts of the latest IRS ruling on the subject of transfer for value?

*There had previously been a number of private letter rulings that reached the conclusion that if one sells a life insurance policy to a defective grantor trust, it is treated as a transfer to the insured grantor because the grantor trust is disregarded for income tax purposes. However, Rev. Rul. 2007-13 represents the first time the IRS has put this conclusion into a published ruling.*

**Dr. Slavutin:** The ruling is Rev. Rul. 2007-13, I.R.B. 2007-11, 684. In this ruling, the IRS considered the implications of the transfer of a life insurance policy in two separate situations involving trusts. In the first situation, there are two trusts, each of which is a grantor trust that is treated as wholly owned by the grantor for federal income tax purposes. Trust 2 transfers a life insurance policy it owns on the life of the grantor to Trust 1 in exchange for cash. The second situation is exactly the same as the first, except that in this instance, Trust 2 is not a grantor trust.

**CCH:** What conclusions did the IRS reach?

**Dr. Slavutin:** With respect to the first situation, the IRS reasoned that it was not a transfer for valuable consideration within the meaning of Code Sec. 101(a)(2). Following the rationale of Rev. Rul. 85-13, 1985-1 CB 184, a transaction between a grantor and a trust that is treated as wholly owned by the grantor for income tax purposes is to be disregarded. Consequently, the grantor was treated as the owner of both trusts and their assets (the insurance policy and any cash received in exchange for it), so that the transaction as a whole could be disregarded.

As to the second situation, the IRS found that there was in fact a transfer of property and it was a transfer for valuable consideration—cash. At that point, the IRS turned to the exceptions to the general transfer-for-value rule. There had previously been a number of private letter rulings that reached the conclusion that if one sells a life insurance policy to a defective grantor trust, it is treated as a transfer to the insured grantor because the grantor trust is disregarded for income tax purposes. However, Rev. Rul. 2007-13 rep-

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## CONSULTING EDITOR SIDNEY KESS HONORED BY BARUCH COLLEGE

On February 21, CCH Consulting Editor Sidney Kess was honored by Baruch College at the City University of New York for his outstanding contributions in the field of taxation. Mr. Kess, a 1948 graduate of the College offered remarks and addressed MS and MBA students in taxation attending the College's Zicklin School of Business. Attendees included representatives from the American Institute of Certified Public Accountants (AICPA), the New York State Society of CPAs, and the major accounting firms.

Mr. Kess is a contributor to many CCH products, including *ESTATE PLANNING REVIEW*, *FINANCIAL AND ESTATE PLANNING*, *BUSINESS STRATEGIES*, and the author of numerous books and CPE courses, including the *1040 Preparation Course*, the *Financial and Estate Planning Course*, and the *Federal Tax Audio Advisor*. Mr. Kess is also a well-traveled speaker, having lectured to thousands of practitioners on tax and financial planning subjects at seminars, such as the AICPA's *Tax Strategies for High-Income Taxpayers* series. He is often quoted in the *Wall Street Journal*, the *New York Times*, and other national publications.

resents the first time the IRS has put this conclusion into a published ruling. Up until this point, if a client approached a practitioner with this fact pattern, the most the practitioner could say was that "it should work" based on the private letter rulings, but those letter rulings could not be relied on by anyone other than the persons who requested the rulings.

For example, I know of an attorney whose client had a very large life insurance policy owned by a trust, but the trust was not properly drafted to protect the beneficiaries (the grantor's children) from creditors and there was concern about the possibility of litigation. In this case, the attorney had to seek a private letter ruling on the transfer-for-value question before attempting to transfer the policy from one trust to another.

### Grantor Trust Status

**CCH:** Beyond that point, what do you see as the lesson we can take away from this ruling?

**Dr. Slavutin:** The ruling illustrates the importance of using a so-called intentionally defective grantor trust that is considered defective for income tax purposes because the grantor is responsible for paying the income taxes, but still effective for transfer tax purposes in that the assets involved have been irrevocably transferred out of the grantor's estate. An added advantage to this is that, assuming the requirements of Rev. Rul. 2004-64, 2004-2 CB 7, are met, the grantor's payment of income taxes is effectively a gift to the beneficiaries that is not taxed under the gift tax regime. To avoid inclusion of the trust's assets in the grantor's estate, Rev. Rul. 2004-64 states that the trust's governing instrument or local law cannot require the trust to reimburse the grantor for income taxes paid by him or her. Rev. Rul. 2004-64 goes on to say that if the trust's governing instrument or local law provides the trustee with only the discretion to reimburse the grantor

for the taxes paid, regardless of whether the discretion is actually exercised, that is not enough (without some other evidence, such as of a pre-existing arrangement between the parties) to cause inclusion of the trust assets in the grantor's gross estate.

**CCH:** Did the ruling leave some questions unanswered?

**Dr. Slavutin:** Yes, one remaining issue is, how does one know that a trust is truly a defective grantor trust? There is a whole body of law on the issue—the grantor trust rules of Code Secs. 671 through 679. Sometimes, advisors come to the erroneous conclusion that, just by virtue of the fact that a trust has been established as an insurance trust to purchase life insurance on the grantor's life and to use the income from the trust to pay the premiums, the trust is a defective grantor trust. This is not necessarily the case because the trust may not be defective with respect to both income and principal. Beyond the provision relating to the use of trust income to pay the insurance premiums, there has to be some other provision in the trust instrument to trigger the grantor trust rules, such as a provision allowing the grantor the power, in a nonfiduciary capacity, to reacquire the trust corpus by substituting property of equivalent value. The point is that if a transaction requires that the trust be defective for income tax purposes both with respect to income and principal, it is best to consult with a practitioner who is well versed in the operation of the grantor trust rules.

### Sales Price of Policy

Another open question is, how do you determine the sale price when transferring a policy from one trust to another? Generally, the sales price is the fair market value of the policy. In order to determine fair market value, historically, we looked to the gift tax regulations (Reg. §25.2512-6) for guidance. Under those rules, the

value of a term life insurance policy is the value of the unearned premiums. For a conventional cash value policy, the value is the interpolated terminal reserve value, plus the unearned premiums. If the policy has been in existence for a relatively short time (e.g., less than one year), the value is the amount paid in premiums. In any case, the insurance company will issue a Form 712 (Life Insurance Statement) to provide the value.

However, the valuation issue has become more complicated recently. In 2005, the IRS issued Rev. Proc. 2005-25, 2005-1 CB 962, addressing the valuation of life insurance policies sold or distributed by retirement plans. The IRS was attempting to curb certain abuses involving life insurance policies being sold from a retirement plan to a life insurance trust for a ridiculously low price because of the inclusion of a high surrender charge. Rev. Proc. 2005-25 introduced new valuation rules to eliminate this abuse. This methodology is called the PERC valuation method (premiums plus interest minus reasonable expenses and mortality charges). Working with these new rules we have found that the resulting value is generally not less than 60 or 70 percent of what has been paid in premiums. Although Rev. Proc. 2005-25 is ostensibly targeted at sales of life insurance policies from retirement plans, it is reasonable to assume that the IRS would apply the same method of valuing policies in the estate and gift tax area, especially if the reserve or cash surrender values were significantly less than the cumulative premiums paid.

### Practical Implications of Rev. Rul. 2007-13

**CCH:** As a practical matter, when would it be appropriate to sell a policy from one trust to another?

**Dr. Slavutin:** Earlier, I mentioned the situation in which the terms of a life insurance trust failed to provide the desired level of creditor protection for the beneficiaries. This illustrates the broader point that, if a trust holding life insurance has some kind of inherent problem, but there is a reason to retain the underlying insurance policy, one should look at the possibility of selling the policy from the old trust to a new trust, which has more desirable provisions. For example, if the insured party is no longer insurable and he informs you that, under the terms of his insurance trust, the proceeds of his life insurance policy are to be paid to his children in a lump sum and he would prefer that they be paid over time. An even worse scenario occurs if the trust was drafted to require the insurance proceeds to be used to pay estate taxes. If left alone, that result would effectively negate the whole reason for establishing a life insurance trust in the first place, because it causes inclusion of the insurance proceeds in the estate for federal estate tax purposes. Selling the insurance policy to a new trust with the correct provisions can solve the problem of a good policy in a bad trust.

**CCH:** What alternatives are available to a sale of the policy?

**Dr. Slavutin:** In several states (New York and Delaware, for example) it is possible to transfer an asset like an insurance policy from one trust to another if the trustee of the first trust has the unlimited right to invade principal. Also, one cannot adversely impact the income rights of the beneficiaries when transferring an asset from one trust to another.

### Transfer for Value: Disguised Consideration

**CCH:** Although the transfer-for-value rules may seem fairly straight forward at first glance, that is not necessarily always the case. Could you describe some scenarios in which practitioners might be tripped up by these rules?

**Dr. Slavutin:** In the business and estate planning area there are at least two instances that can provide a trap to the unwary. The first such instance is the transfer of a policy by gift from a parent to a child, where the policy is subject to a loan. Even though we are discussing a transfer by gift rather than a sale, there is a potential problem. The gift effectively eliminates the liability of the parent to pay the loan, and, thus, the parent is receiving consideration in the form of debt relief. The amount of the debt relief is the amount of the outstanding loan. If the loan amount is greater than the parent's basis in the policy there would be a two-fold tax impact. For example, if the loan amount was \$100,000 and the basis was \$60,000, there would be an immediate taxable gain of \$40,000 in ordinary income, not capital gain. An even worse result is that the Code Sec. 101 income tax exclusion for the death benefit from the life insurance policy has been lost, subjecting the death benefits to income tax to the extent the benefit exceeds the donee's basis when the donor dies. Transfer for value has been triggered because debt relief is a form of consideration. However, there will not be a transfer-for-value problem if the amount of the loan is less than or equal to the parent's basis in the policy.

Another example where transfer for value can occur unexpectedly involves the transfer of a policy to a co-shareholder in restructuring a redemption buy-sell agreement. Redemption agreements have become less popular in recent years with C corporations because of potential alternative minimum tax problems. As a result, one option that some clients have considered is a transfer of the policy from the corporation to the shareholders and a change of the redemption agreement to a cross-purchase agreement. For example, a corporation with two 50-percent shareholders transfers the policy on the life of Shareholder A to Shareholder B and the policy on the life of Shareholder B to Shareholder A. However, there is a major problem with this

approach and that is because there is no exception under Code Sec. 101(a)(2) for a transfer to a co-shareholder.

However, one might argue that even though there has been a transfer to a shareholder there has been no consideration given by either shareholder in exchange for their respective policy. This issue was addressed many years ago in *Monroe v. Patterson*, DC-Ala., 61-2 USTC ¶9,555. Under the rationale of that case, there was valuable consideration transferred because the corporation has been relieved of the obligation to pay the insurance premiums as well as the obligation to redeem the stock when the shareholder dies. This is another prime example of a transfer for value occurring without any cash changing hands but, instead, with some disguised form of consideration. Yet another instance of how the transfer-for-value rules can have a negative impact when you least expect it.

### Conclusion

In conclusion, Rev. Rul. 2007-13 opens the door to sell a life insurance policy to a defective grantor trust and avoid transfer for value, without needing to obtain a private letter ruling for your client. This technique is particularly useful when a trust owns a life insurance policy and the trust has some problematic provision that cannot be changed because the trust is irrevocable. The revenue ruling enables the client to move the policy from the problem trust to a new and better drafted trust and avoid transfer for value. ♦

## ESTATE TAX

### Claims Against Estates Were Unenforceable

The estate of Jim Henson, creator of the Muppets, was not entitled to a Code Sec. 2053(a)(3) deduction because the surviving spouse did not have a valid claim

*In recent decisions, two estates were not entitled to claim deductions under Code Sec. 2053(a)(3). Although both estates asserted deductions for claims against the estate, neither estate could prove that an enforceable claim against the estate existed. The courts also ruled on valuation discounts for pledged securities, a claim for the marital deduction, and inclusion of misappropriated assets in the gross estate.*

against the estate (*A. Gottesman, Exr.*, DC N.Y., 2007-1 USTC ¶60,536). Deductions for claims against an estate are limited to those claims that are allowable and enforceable personal obligations of the decedent under applicable state law.

Mr. Henson and his wife entered into a separation agreement about three years before his death. Pursuant

to the agreement, Mrs. Henson transferred 35 shares of Henson Associates, Inc., a closely held company, to Mr. Henson. In return, Mr. Henson agreed to pay a portion of any proceeds from a sale or merger of the company if Mr. Henson received “value” during Mrs. Henson’s lifetime. The agreement defined “value” as money or other assets received by Mr. Henson or his estate as the result of a sale or merger. In connection with the agreement, Mr. Henson delivered the 35 shares transferred by Mrs. Henson to an escrow agent as security for Mr. Henson’s obligations to his wife under the agreement. Mr. Henson died on May 16, 1990. He bequeathed his shares to their children. Nearly 10 years after Mr. Henson’s death, his children sold the company. Because the children believed that they did not have unencumbered title to the shares held in escrow, the children obtained Mrs. Henson’s approval to remove the shares from escrow in order to sell the company. The children, Mrs. Henson, and the estate entered into an agreement, under which the children paid Mrs. Henson \$10,660,000, in satisfaction of her claims under the separation agreement. Following the payment to Mrs. Henson, the children sought an estate tax refund claim of \$4,157,000 plus interest.

The court noted that the agreement specifically defined value as the receipt of money by Mr. Henson or his estate and specifically excluded amounts received by the children. Therefore, when the children sold the company, Mrs. Henson was not entitled under the agreement to any portion of the proceeds. The court also rejected the estate’s argument that Mrs. Henson was entitled to a portion of the proceeds because the escrow agreement was not terminated upon Mr. Henson’s death. The escrow agreement did not establish the estate’s obligation to Mrs. Henson because it was merely a means to provide security for Mr. Henson’s obligations under the separation agreement. Accordingly, after the shares were transferred to the children, the estate no longer had an interest in the company and could not receive value from a sale or merger. As a result, Mrs. Henson did not have an enforceable claim against the estate and the estate was not entitled to a deduction under Code Sec. 2053(a)(3). In addition, the full value of the shares was includible in Mr. Henson’s estate. Mrs. Henson did not have an enforceable claim against the estate and, thus, there was no liability by which to reduce the shares’ value. The court also held that the estate was not entitled to a marital deduction under Code Sec. 2056(a) because an interest in the company passed from Mr. Henson to his children, not to Mrs. Henson.

### Misappropriated Assets Includible in Gross Estate

Prior to his death, Mr. Hester was the income beneficiary and trustee of a trust established by his prede-