PART I: LIFE INSURANCE

In General

1. What is life insurance?

Life insurance is a contract under which, in exchange for premium payments, an insurance company agrees to pay a death benefit if the person whose life is insured dies while the contract is in force. There are two general categories of life insurance: term coverage and permanent coverage. Term coverage is for a specific period of time, which can last for as little as one year or possibly as long as thirty years. Permanent insurance is intended to cover an insured for the rest of the insured's life. Permanent life insurance can be financed with a single premium, a fixed number of premiums over several years, or premiums paid over the remainder of the insured's life.

Premiums

2. Are premiums paid on personal life insurance deductible for income tax purposes?

No. Premiums paid on personal life insurance are a personal expense and are not deductible.[1] Internal Revenue Service (IRS) regulations specifically provide that "[p]remiums paid for life insurance by the insured are not deductible."[2] It is immaterial whether the premiums are paid by the insured or by some other person. For example, premiums paid by an individual for insurance on the life of his or her spouse are nondeductible personal expenses of the individual. Premiums are not deductible regardless of whether the insurance is government life insurance or regular commercial life insurance.[3] Although personal life insurance premiums, as such, are not deductible, they may be deductible as the payment of alimony (Q 104) or as charitable contributions (Q 115 to Q 122).

3. Can a taxpayer deduct interest paid on a loan to purchase or carry a life insurance, endowment, or annuity contract?

Single Premium Contract

Interest paid or accrued on indebtedness incurred to purchase or continue in effect a single premium life insurance, endowment, or annuity contract purchased after March 1, 1954, is not deductible.[4] For this purpose, a single premium contract is defined as one on which substantially all the premiums are paid within four years from the date of purchase, or on which an amount is deposited with the insurer for payment of a substantial number of future premiums.[5] One court has held that payment in the first four years of 73 percent of total annual premiums for a limited-pay policy did not constitute payment of "substantially all" of the premiums.[6]

1. IRC Secs. 262(a) and 264.
2. Treas. Reg. §1.262-1(b)(1).
3. *Kutz v. Comm.*, 5 BTA 239 (1926).
4. IRC Sec. 264(a)(2).
5. IRC Sec. 264(c).
6. *Dudderar v. Comm.*, 44 TC 632 (1965), acq. 1966-2 CB 4.

Another court has ruled that payment of eight annual premiums in the first four years on a whole life policy was neither "substantially all" nor a "substantial number" of the premiums.[1]

When a single premium annuity is used as collateral to either obtain or continue a mortgage, the IRS has found that Internal Revenue Code (IRC) Section 264(a)(2) disallows the allocable amount of mortgage interest to the extent that the mortgage is collateralized by the annuity. However, this result does not hold when a taxpayer's use of available cash to purchase an annuity results in a larger home mortgage or when a taxpayer does not surrender an annuity even though cash obtained from the surrender would make it possible to reduce the amount of the mortgage.[2] A general counsel memorandum has concluded that borrowing against the cash value of a single premium life insurance policy is equivalent to using the policy as collateral.[3]

In restating the rule concerning single premium contracts, the conference committee report accompanying the Tax Reform Act of 1986 (TRA '86) states that "no inference is intended that universal life insurance policies are always treated as single premium contracts."[4] It is still unclear whether the four exceptions applicable to contracts other than single premium contracts, discussed in Q 4, can be used in the case of universal life contracts.

Other than Single Premium Contract

A deduction is denied under IRC Section 264(a)(3) for interest on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract, that is not a single premium contract, if it is purchased pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).

4. Are there any exceptions to the rule that disallows a deduction for interest paid on a loan to purchase or carry a life insurance, endowment or annuity contract?

There are four exceptions to this disallowance rule.[5] However, with respect to interest paid or accrued on policies or contracts covering an individual who is a "key person," the deduction may be limited as explained in Q 30, even if one of the four exceptions to this disallowance rule is met, or even denied.

The four exceptions are:

(1) *The seven-year exception*. The deduction will not be disallowed under this rule when no part of four of the annual premiums due during the seven-year period, beginning with the date of payment for the first premium on the contract, is paid by

1. *Campbell v. Cen-Tex, Inc.*, 377 F. 2d 688 (5th Cir. 1967).
2. Rev. Rul. 95-53, 1995-2 CB 30.
3. GCM 39534 (7-17-86).
4. H.R. Conf. Rep. No. 99-841 (TRA '86) *reprinted in* 1986-3 CB 341. See also General Explanation of the Tax Reform Act of 1986 at pp. 579, 580.
5. IRC Sec. 264(d).

means of indebtedness. If there is a substantial increase in the premiums, a new seven-year period for the contract commences on the date the first increased premium is paid. However, a new seven-year period does not begin upon transfer of the policy, whether for value or by gift.[1] A new seven-year period does not commence if modification of a life insurance policy after December 31, 1990, becomes necessary because of the insurer's financial insolvency.[2] The addition to a policy of a provision that interest on policy loans is payable in arrears rather than in advance will not cause a new seven-year period to begin.[3] A systematic plan of purchase will be presumed when there is borrowing in connection with more than three of the annual premiums due during the seven-year period, but will not be presumed earlier.[4]

Once a taxpayer has used borrowed funds to pay the first four premiums, the taxpayer cannot undo the effect of this action by repaying the policy loan.[5] If in any year during the seven-year period, the taxpayer in connection with any premium borrows more than an amount necessary to pay one annual premium, the excess will be considered to have been borrowed to pay premiums that have been paid in prior years with non-borrowed funds (beginning with the first prior year and working backwards).[6]

Example. Taxpayer, in Year 1, purchased a $100,000 policy and the annual premium was $2,200. The taxpayer paid the first four premiums without borrowing. In Year 5, the taxpayer borrowed $10,000 with respect to the policy. The borrowing will be attributed first to paying the premium for Year 5 and then attributable to paying the premium for Years 4, 3, 2, and 1 (in part).

If borrowing in connection with any premium in any year exceeds the premium for that year *plus* premiums paid in prior years without borrowing, the excess will be attributed to premiums (if any) paid in advance for future years. However, once the seven-year exception has been satisfied, and the seven-year period has expired, there would appear to be no limit under this exception to the amount that might be borrowed (from the policy or otherwise) to pay premiums on the policy. (But if a substantial number of premiums are *prepaid*, the policy might be considered a single-premium policy – see Q 3.)

Thus, three of the first seven annual premiums may be borrowed, and the interest deduction would not be disallowed by reason of this rule, provided the balance of premiums during the seven-year period is paid with non-borrowed funds. But if the seven-year exception is not met, and the taxpayer cannot rebut the presumption of a systematic plan of borrowing, the interest deduction will be disallowed under this rule for all future years and for all prior years not closed by

1. Rev. Rul. 71-309, 1971-2 CB 168.
2. Rev. Proc. 92-57, 1992-2 CB 410; Let. Rul. 9239026.
3. Let. Rul. 9737007.
4. Treas. Reg. §1.264-4(c).
5. Rev. Rul. 72-609, 1972-2 CB 199.
6. See Treas. Reg. §1.264-4(c)(ii).

the statute of limitations. This assumes, of course, that none of the other exceptions to this rule applies.[1]

(2) *$100-a-year exception*. Regardless of whether there is a systematic plan of borrowing, the interest deduction will not be disallowed under this rule for any taxable year in which the interest (in connection with such plans) does not exceed $100. But when such interest exceeds $100, the entire amount of interest (not just the amount in excess of $100) is nondeductible under IRC Section 264(a)(3).[2]

(3) *Unforeseen event exception*. If indebtedness is incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in the taxpayer's financial obligations, the deduction will not be disallowed under this rule even though the loan is used to pay premiums on the contract. An event is not "unforeseen," however, if at the time the contract was purchased it could have been foreseen.[3]

(4) *Trade or business exception*. If indebtedness is incurred in connection with the taxpayer's trade or business, the interest deduction will not be denied under IRC Section 264(a)(3). Thus, if an insurance policy is pledged as part of the collateral for a loan, the interest deductions will come within this exception if the taxpayer can show that the amounts borrowed actually were used to finance the expansion of inventory or other similar business needs.[4] The IRS has ruled privately that a company that borrowed against key-person life insurance policies to take advantage of the policies' lower interest rate and generally to improve its financial position by reducing its overall debt was considered to have incurred the policy loan interest in connection with its trade or business.[5] But borrowing to finance business life insurance (such as key person, split dollar, or stock purchase plans) is not considered to be incurred in connection with the borrower's trade or business.[6] Systematic borrowing to finance a life insurance policy is not debt incurred in connection with an employer's trade or business even when the net death proceeds and the amounts borrowed in excess of premiums are used to fund employee retirement benefits.[7]

The interest deduction will not be disallowed under IRC Section 264(a)(3) if any one of these exceptions applies. For example, even though the purchase of business life insurance does not come within the trade or business exception, the interest deduction may be allowed if the borrowing comes within the four-out-of-seven exception, provided no other IRC section operates to disallow or limit the interest deduction (Q 30).

1. Treas. Reg. §1.264-4(d)(1).
2. Treas. Reg. §1.264-4(d)(2).
3. Treas. Reg. §1.264-4(d)(3).
4. See Treas. Reg. §1.264-4(d)(4).
5. Let. Rul. 9138049.
6. *American Body & Equipment Co. v. U.S.*, 511 F.2d 647 (5th Cir. 1975).
7. Rev. Rul. 81-255, 1981-2 CB 79.

5. How is a systematic plan of borrowing to buy life insurance treated?

In one revenue ruling, IRS found systematic borrowing in a plan that contemplated purchase of mutual fund shares and a policy of whole life insurance by an insured's use of the shares as security for notes executed each year in the amount of the cumulative premium and accrued interest.[1] When there is a systematic plan of borrowing, the borrowing will be treated as a plan for borrowing the increases in cash value of the policy, regardless of whether the borrowing is direct or indirect (that is, regardless of whether the borrowing is from the insurer, a bank, or some other person). Moreover, such a plan need not involve a pledge of the contract, but may contemplate unsecured borrowing or the use of other property.[2] When there is a systematic plan, and none of the exceptions applies, a deduction will be disallowed for interest on the entire amount borrowed, not just for interest on the borrowing equal to the increases in the cash value.[3]

Historically, the general disallowance rule applies only with respect to life insurance contracts purchased after August 6, 1963. However, IRS regulations state that this date relates to the date of purchase by the taxpayer, whether the purchase is from the insurer or from a previous policy owner. When a policy issued in 1959 was to be exchanged, the purchase date of the new policy was considered the date upon which the exchange was made, with the taxpayer losing the benefit of a policy issued prior to August 6, 1963.[4]

6. Can the rules that disallow a deduction for interest paid on a loan to purchase or carry a life insurance, endowment or annuity contract be avoided by having one spouse use funds borrowed by the other spouse?

These disallowance rules cannot be avoided by having one spouse use funds borrowed by the other. When a husband borrowed money and transferred it to his wife, who used it to buy tax-exempt securities, the interest deduction was denied on the basis that the transfer of the borrowed funds was without economic substance because the purpose of the husband's borrowing was to enable the wife to buy tax-exempt securities.[5]

7. Is the interest increment earned on prepaid life insurance premiums taxable income?

Yes. Any increment in the value of prepaid life insurance or annuity premiums or premium deposit funds constitutes taxable income in the year it is applied to the payment of a premium or is made available for withdrawal, whichever occurs first.[6] The interest treated as taxable income, however, will be included in the cost basis of the contract. Thus, for purposes of IRC Section 72, the cost of the contract would be the amount of premiums paid other than by discount, plus the amount of discounted funds and any increments on such funds that were subject to income taxation.

1. Rev. Rul. 74-500, 1974-2 CB 91.
2. Treas. Reg. §1.264-4(c)(2).
3. Treas. Reg. §1.264-4(b).
4. GCM 39728 (4-29-88).
5. Rev. Rul. 79-272, 1979-2 CB 124 (citing *Drybrough v. Comm.*, 42 T.C. 1029 (1964)).
6. Rev. Rul. 65-199, 1965-2 CB 20.

The rule taxing interest increments has no applicability, however, to single premium policies. A later ruling explains in detail how the interest will be taxed.[1]

Cash Value Increases

8. Are annual increases in the cash surrender value of a life insurance policy taxable income to the policyholder?

In a case involving a cash basis taxpayer, the Tax Court held that the cash values were not constructively received by the taxpayer where the taxpayer could not reach them without surrendering the policy. The necessity of surrendering the policy constituted a substantial "limitation or restriction" on their receipt.[2] Likewise, the Tax Court has held that the cash surrender values of paid-up additions are not constructively received by the policyholder.[3] Similarly, it would appear that the same "limitation or restriction" would prevent accrual for an accrual basis taxpayer, because income does not accrue until "all the events have occurred" that fix the right to receive the income.[4] The same rule applies whether the policy is a single premium policy or a periodic premium policy.

Tax on the "inside buildup" of cash surrender values generally is not deferred in the case of contracts issued after December 31, 1984, that do not meet the statutory definition of a "life insurance contract" (Q 64).[5] In such cases, the *excess* of the sum of (1) the increase in net surrender value (cash surrender value less any surrender charges) during the taxable year and (2) the cost of life insurance protection for the year *over* premiums paid under the contract during the year is taxable to the policyholder as ordinary income.[6] "Premiums paid" generally means those paid under the contract less amounts received but excludable from income under IRC Section 72(e) (e.g., dividends).[7] The cost of life insurance protection is the lesser of the cost of individual insurance on the life of the insured determined on the basis of uniform premiums or the mortality charge, if any, stated in the contract.[8] If the contract originally meets the statutory definition and then ceases to do so, income on the contract for all prior years is included in gross income in the year it ceases to meet the definition.[9]

If a variable insurance contract is an insurance contract under applicable state law and would otherwise meet the definitional requirements of IRC Section 7702, the annual increases in cash surrender value may nevertheless be taxed under the rules in the above paragraph if the underlying segregated asset account is not adequately diversified (Q 480).

If a policy does not meet the IRC Section 7702(a) definition of a life insurance contract, the income on the contract for the year is considered a nonperiodic distribution and is

1. Rev. Rul. 66-120, 1966-1 CB 14.
2. *Cohen v. Comm.*, 39 TC 1055 (1963), *acq.* 1964-1 CB 4.
3. *Nesbitt v. Comm.*, 43 TC 629 (1965).
4. Treas. Reg. §1.446-1(c)(1)(ii).
5. IRC Sec. 7702(g).
6. IRC Sec. 7702(g)(1)(B).
7. IRC Sec. 7702(f)(1).
8. IRC Sec. 7702(g)(1)(D).
9. IRC Sec. 7702(g)(1)(C).

subject to certain reporting and withholding requirements. The same is true for a variable life insurance contract that does not meet the diversification requirements of regulations under IRC Section 817(h).[1]

The "inside buildup" of cash surrender values of corporate-owned life insurance is generally included in the calculation of the alternative minimum tax (Q 300).

9. Is the owner of a limited-pay life insurance policy liable for any tax when the policy becomes paid-up?

No. Taxable income is not realized unless the policy is sold or surrendered.

Living Proceeds

10. What are the rules for taxing living proceeds received under life insurance policies and endowment contracts?

Generally speaking, living proceeds are proceeds received during an insured's lifetime. The rules in IRC Section 72 govern the income taxation of amounts received as *living proceeds* from life insurance policies and endowment contracts. IRC Section 72 also covers the tax treatment of policy dividends and forms of premium returns.

Payments to which IRC Section 72 applies are of three classes: (1) "amounts not received as an annuity," (2) payments of interest only, and (3) "amounts received as annuities."

When living proceeds are held by an insurer under an agreement to pay interest, the interest payments are taxable in full (Q 21).[2] Periodic payments on a principal amount that will be returned intact on demand are interest payments.[3]

All amounts taxable under IRC Section 72 other than annuities and payments of interest are classed as *amounts not received as an annuity*. These include policy dividends, lump-sum cash settlements of cash surrender values and endowment maturity proceeds, and cash withdrawals and amounts received on partial surrender.[4]

The income tax treatment of life insurance *death proceeds* is governed by IRC Section 101, not by IRC Section 72. Consequently, the annuity rules in IRC Section 72 do not apply to life income or other installment payments under optional settlements of death proceeds. However, the rules for taxing such payments are similar to IRC Section 72 annuity rules (Q 62 to Q 74).

Living proceeds received under life insurance contracts and endowment policies are taxed according to the same rules, whether they are single premium or periodic premium policies. Except for interest and annuity settlements, they are taxed under the "cost recovery rule" no matter when the contract was entered into or when premiums were paid. In other words, such amounts are included in gross income only to the extent they exceed the investment in the

1. Rev. Rul. 91-17 1991-1 CB 190, as amplified by Rev. Proc. 2008-41, 2008-2 CB 155.
2. IRC Sec. 72(j); Treas. Reg. §1.72-14(a).
3. Rev. Rul. 75-255, 1975-2 CB 22.
4. Treas. Reg. §1.72-11.

contract (as reduced by any prior excludable distributions under the contract). Living proceeds or distributions received from a life insurance policy that has failed the seven pay test of IRC Section 7702A(b) and, therefore, is classified as a modified endowment contract are taxed under different rules (Q 119).

Planning Point: Assuming no policy loans, dividends, or prior cash value surrenders, a life insurance contract can be surrendered with no taxable gain, provided the aggregate premiums are equal to or exceed the cash values (Q 51). Assume after fifteen years the aggregate premiums of a universal life policy are equal to the cash values, the policy is surrendered, and nothing is included in gross income. Over the life of this contract ***untaxed*** interest earnings have been used to pay the mortality charges (i.e., the amount-at-risk element of the contract). In contrast, if term insurance had been originally purchased, premiums would have come from after-tax income. *Donald F. Cady, J.D., LL.M, CLU*.

11. How are cash distributions received as a result of changes in the benefits of a life insurance contracts taxed?

Cash distributions received as a result of certain changes in the benefits of a contract may not be taxed under the cost recovery rule, but are taxed under the "interest-first" rule. Any change in the benefits under a life insurance contract or in other terms of the contract (other than automatic increases such as change due to the growth of the cash surrender value, payment of guideline premiums, or changes initiated by the company) that was not reflected in any earlier determination or adjustment will require a redetermination as to whether the definitional guidelines of IRC Section 7702 are still satisfied (Q 64).[1] (A modification made to a life insurance contract after December 31, 1990, that is necessitated by the insurer's financial insolvency, however, will not cause retesting under IRC Sections 7702(f)(7)(B)-(E).)[2] If such a change occurs during the fifteen-year period beginning on the issue date of the policy *and* reduces the benefits under the contract, then any cash distribution made to the policyholder as a result of such change will be taxed as ordinary income to the extent there is income on the contract; however, the amount to be included will be limited to the applicable recapture ceiling.[3]

If the change occurs during the five-year period beginning on the issue date of a traditional life policy (that is, a policy that originally qualified under IRC Section 7702 by satisfying the cash value accumulation test), the recapture ceiling is the *excess of* the cash surrender value of the contract immediately before the reduction *over* the net single premium immediately after the reduction. If the change occurs during the five-year period beginning on the issue date of a universal life policy (that is, a policy that originally qualified under IRC Section 7702 by satisfying the guideline premium/cash value corridor tests), the recapture ceiling is the greater of (1) the *excess of* the aggregate premiums paid under the contract immediately before the reduction *over* the guideline premium limitation for the contract, taking into account the proper adjustment for the change in benefits, or (2) the *excess of* the cash surrender value of the contract immediately before the reduction *over* the cash value corridor immediately after the reduction.[4]

1. IRC Sec. 7702(f)(7)(A).
2. Rev. Proc. 92-57, 1992-2 CB 410; Let. Rul. 9239026.
3. IRC Sec. 7702(f)(7)(B).
4. IRC Sec. 7702(f)(7)(C).

If the change occurs after the five-year period and during the fifteen-year period beginning on the date of issue of the policy, the recapture ceiling is the *excess of* the cash surrender value of the contract immediately before the reduction *over* the cash value corridor immediately after the reduction.[1]

Distributions made in anticipation of a reduction in benefits under the contract will be treated as resulting from a change in the contract. Any distribution that reduces the cash surrender value of a contract and that is made within two years before a reduction in benefits under such contract will be treated as made in anticipation of a reduction.[2]

The IRS has provided examples of how these rules work.[3]

12. How are policy loans under life insurance policies and endowment contracts treated?

Policy loans under life insurance policies and endowment contracts are not treated as distributions (Q 29). However, the treatment differs for loans made from life insurance policies classified as modified endowment contracts (Q 13).[4]

If a loan is still outstanding when a policy is surrendered or allowed to lapse, the borrowed amount becomes taxable at that time to the extent the cash value exceeds the owner's basis in the contract, as if the borrowed amount was actually received at the time of surrender or lapse and used to pay off the loan. (If a policy loan is outstanding at the time of an IRC Section 1035 tax-free exchange, the amount of the *net* reduction, if any, in the taxpayer's outstanding loan will be considered "boot" (Q 44) and taxable as ordinary income at that time to the extent there is income on the contract, without regard to basis.) If a loan is outstanding at the time of death, the distribution of the face amount of the policy will be reduced by the amount of the outstanding loan. Proceeds received on account of the death of the insured are generally tax-free (Q 62). The benefit of tax-free death proceeds in excess of cost may be lost, however, in the case of a policy transferred for value (Q 264 to Q 275).

13. For tax purposes, what is a life insurance policy that is classified as a modified endowment contract (MEC)?

A modified endowment contract (MEC) is one that meets the requirements of IRC Section 7702 (Q 64), was entered into on or after June 21, 1988, and fails to meet the seven pay test (Q 14). A contract that is received in exchange for a contract meeting this definition is also an MEC.[5] Distributions from MECs are subject to taxation rules that differ from the rules governing the taxation of distributions from life insurance policies that are not MECs (Q 15).

1. IRC Sec. 7702(f)(7)(D).
2. IRC Sec. 7702(f)(7)(E).
3. Rev. Rul. 2003-95, 2003-33 IRB 358.
4. IRC Secs. 72(e)(5)(A)(i), 7702(f)(7)(B)(iii).
5. IRC Sec. 7702A(a).

14. What is the "seven pay test" and how does it apply to a modified endowment contract (MEC)?

A life insurance contract will fail the seven pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of the seven level annual payments.[1] Generally, the "amount paid" under the contract is defined as the premiums paid less distributions, not including amounts includable in gross income.[2] An amount received as a loan or the repayment of a loan does not affect the amount paid under the contract.[3] Additionally, amounts paid as premiums during the contract year but returned to the policyholder with interest within sixty days after the end of the contract year will reduce the sum of the premiums paid during the contract year. The interest paid on the premiums returned must be included in gross income.[4]

When a whole life insurance policy is coupled with an increasing whole life rider plus a term insurance rider, and the amount of coverage provided under the term rider increases or decreases solely in relation to the amount of coverage provided by the base policy and whole life rider, the IRS has ruled privately that the policy's "future benefits" for purposes of IRC Section 7702A(b) are equal to the aggregate amount of insurance coverage provided under the base policy, the whole life rider, and the term insurance rider at the time the policy is issued.[5] When a variable whole life policy is coupled with a twenty-year decreasing term rider, the future benefits for purposes of IRC Section 7702A(b) are equal to the coverage under the base policy plus the lowest amount of coverage under the term rider at any time during the first seven contract years.[6]

The seven level premiums are determined when the contact is issued, and the first contract year death benefit is deemed to be provided to the contract's maturity, disregarding any scheduled death benefit decrease after the first seven years.[7] In one private letter ruling, the death benefit for purposes of applying IRC Section 7702A(c)(1)(B) was the policy's "target death benefit," defined as the sum of the base policy death benefit and a rider death benefit.[8]

If there is a reduction in benefits under the contract within the first seven contract years, the seven pay test is applied as if the contract had originally been issued at the reduced benefit level. Any reduction in benefits due to the nonpayment of premiums is not taken into account, however, if the benefits are reinstated within ninety days after the reduction.[9]

In the case of a contract that pays a death benefit only on the death of one insured that follows or occurs at the same time as the death of another insured, if the death benefit is reduced

1. IRC Sec. 7702A(b).
2. IRC Sec. 7702A(e)(1).
3. H. R. Conf. Rep. No. 100-1104 (TAMRA '88) *reprinted in* 1988-3 CB 593.
4. IRC Sec. 7702A(e)(1).
5. Let. Rul. 9519023.
6. Let. Rul. 9513015.
7. IRC Sec. 7702A(c)(1).
8. Let. Rul. 9741046.
9. IRC Sec. 7702A(c)(2).

below the lowest level of death benefit provided during the contract's first seven years, the MEC rules must be applied as if the contract had originally been issued at that lower benefit level. This rule is effective for contracts entered into on or after September 14, 1989.[1]

15. How are distributions from modified endowment contracts (MECs) taxed?

Generally, distributions from MECs are taxed differently than distributions from policies that meet the seven pay test (Q 10). Distributions, including loans, from an MEC are taxable as income at the time received to the extent that the cash value of the contract immediately before the payment exceeds the investment in the contract.[2] Basically, this means that distributions from MECs are taxed as income first and recovery of basis second. The investment in the contract is increased to the extent that a distribution was includable in the taxpayer's income. A loan that is retained by the insurance company to pay policy premiums is considered an amount received under the contract.[3]

Distributions made during the contract year and any subsequent contract year in which the contract fails the seven pay test are taxed as discussed above. In addition, under IRS regulations, distributions in anticipation of a failure of the seven pay test also are taxed as above. A distribution made within two years prior to the failure of the seven pay test is a distribution made in anticipation of a failure.[4]

This manner of taxation for distributions does not apply to the assignment or pledge of an MEC to pay burial or prearranged funeral expenses if the contract's maximum death benefit does not exceed $25,000.[5]

For the purpose of determining the amount includable in gross income, all MECs issued by the same company to the same policyholder within any calendar year are treated as one MEC. This rule does not apply generally to contracts purchased by a trust described in IRC Section 401(a) that is exempt from tax under IRC Section 501(a), purchased as part of an IRC Section 403(a) plan, or described in IRC Section 403(b), or to an individual retirement annuity or an individual retirement account.[6]

Penalty Tax

A 10 percent penalty tax is imposed on any amount received by a taxpayer under an MEC that is includable in gross income unless the distribution is made after the taxpayer becomes disabled, attains age 59½, or the distribution is part of a series of substantially equal periodic payments made for the taxpayer's life or life expectancy or the joint lives or joint life expectancies of the taxpayer and the taxpayer's beneficiary.[7]

1. IRC Sec. 7702A(c)(6).
2. IRC Sec. 72(e)(10).
3. H. R. Conf. Rep. No. 100-1104 (TAMRA '88) *reprinted in* 1988-3 CB 592.
4. IRC Sec. 7702A(d).
5. IRC Sec. 72(e)(10)(B).
6. IRC Sec. 72(e)(12).
7. IRC Sec. 72(v).

16. Which life insurance contracts are subject to the seven pay test?

Subject to the following exceptions, life insurance contracts entered into after June 20, 1988, are subject to the seven pay test.[1] Contracts entered into prior to this date are "grandfathered" for purposes of the seven pay test.

If the death benefit under a grandfathered contract increases by more than $150,000 over the death benefit in effect as of October 20, 1988, the contract becomes subject to the material change rules (Q 17) and may lose its grandfathered status. This rule does not apply if the contract required at least seven annual premiums as of June 21, 1988, and the policyholder continued to make at least seven annual premium payments.[2] In determining whether a material change has occurred, the death benefit payable as of June 20, 1988, rather than the lowest death benefit payable during the first seven years, is applicable.[3]

A policy entered into before June 21, 1988, may lose its grandfathered status and, therefore, may be treated as if it were entered into after this date, if (1) the policy death benefit is increased or an additional qualified benefit is purchased after June 20, 1988, and (2) prior to June 21, 1988, the contract owner did not have the right to obtain such an increase or addition without providing additional evidence of insurability. If a term life insurance contract is converted after June 20, 1988, to a policy that is not term insurance, without regard to the right of the owner to such a conversion, the policy will lose its grandfathered status.[4] A policy entered into before June 21, 1988, did not lose its grandfathered status when the insurer changed the policy loan provision to make interest payable in arrears rather than in advance.[5] The IRS has stated that modification of a life insurance contract after December 31, 1990, that is made necessary by the insurer's insolvency will not affect the date on which the contract was issued, entered into, or purchased for purposes of IRC Section 7702.[6]

17. How will material changes in the benefits or terms of a life insurance contract be treated for purposes of the seven pay test?

If there is a material change in the benefits or terms, the contract will be treated as a new contract entered into on the day the material change was effective and the seven pay test, with appropriate adjustments to reflect the cash surrender value of the contract, must be met again.[7] Modification of a life insurance contract after December 31, 1990, that is made necessary by the insurer's financial insolvency, however, will not cause commencement of a new seven year period for purposes of the seven pay test.[8]

For a contract that has been materially changed, the seven pay premium for each of the seven years following the change is reduced by the cash surrender value of the contract as of

1. TAMRA '88 Sec. 5012(e)(1).
2. TAMRA '88 Sec. 5012(e)(2), as amended by OBRA '89 Sec. 7815(a)(2).
3. H.R. Conf. Rep. No. 100-1104, (TAMRA '88) *reprinted in* 1988-3 CB 595-596.
4. TAMRA '88 Sec. 5012(e)(3).
5. Let. Ruls. 9714029, 9412023, 9117011.
6. Rev. Proc. 92-57, 1992-2 CB 410.
7. IRC Sec. 7702A(c)(3)(A).
8. Rev. Proc. 92-57, 1992-2 CB 410.

the effective date of the material change multiplied by a fraction, the numerator of which is the seven pay premium for future benefits under the contract and the denominator of which is the net single premium for future benefits under the contract.[1]

A material change is defined as any increase in the death benefit under the contract or any increase in, or addition of, a qualified additional benefit under the contract. However, any increase due to the payment of premiums necessary to fund the lowest level of the death benefit and qualified additional benefits payable in the first seven contract years or to the crediting of interest or other earnings, including dividends, is not considered a material change. Additionally, to the extent provided in IRS regulations, any cost-of-living increase funded over the period during which premiums are required to be paid under the contract and that are based on a broad-based index is not considered a material change.[2]

For purposes of IRC Sections 101(f), 7702, and 7702A, a material change to a contract does not occur when a rider that is treated as a qualified long term care insurance contract under IRC Section 7702B is issued or when any provision required to conform any other long term care rider to these requirements is added (Q 424).[3]

18. Are MEC dividends "amounts received under the contract"?

Any dividend of a MEC that is retained by the insurer to pay either principal or interest on a policy loan is an amount received under the contract. Any dividend that is retained by the insurer for purposes of purchasing paid-up insurance is not an amount received under the contract.[4]

19. Is the exchange of a life insurance policy under IRC Section 1035 subject to the seven pay test?

The effect of an IRC Section 1035 exchange on the grandfathered status of a policy issued prior to June 21, 1988, and thus not subject to the seven pay test of IRC Section 7702A is not entirely clear.[5] In a private ruling, the IRS has taken the position that a life insurance contract received in an IRC Section 1035 exchange for a life insurance contract issued before June 21, 1988, will be considered as issued and entered into on the date that it is received in exchange for the previous contract and, thus, apparently will be subject to the seven pay test.[6]

If a MEC that requires the payment of at least seven annual premiums was entered into after June 20, 1988, but before November 10, 1988, and was then exchanged within the three months following November 10, 1988, for a contract that meets the requirements of the seven pay test, the new contract is not treated as a MEC if the taxpayer recognized gain, to the extent that there was any, on the exchange.[7]

1. H.R. Conf. Rep. No. 100-1104, (TAMRA '88) *reprinted in* 1988-3 CB 595.
2. IRC Sec. 7702A(c)(3)(B).
3. HIPAA '96, Sec. 321(f)(4).
4. See 72(e); see also H.R. Conf. Rep. No. 100-1104, (TAMRA '88) *reprinted in* 1988-3 CB 592.
5. See H.R. Conf. Rep. No. 100-1104, (TAMRA '88) *reprinted in* 1988-3 CB 596.
6. Let. Rul. 9044022.
7. TAMRA '88 Sec. 5012(e)(4).

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20. How can life insurance companies correct failures to comply with the modified endowment contract (MEC) rules?

Life insurance companies may correct "inadvertent non-egregious" failures to comply with the MEC rules by submitting a request for relief to the IRS. The request must meet certain requirements and give detailed information about the MECs at issue. To obtain relief, a life insurance company must pay an amount calculated individually for each policy and bring the policies into compliance with IRC Section 7702A by, generally, increasing the policy's death benefit or refunding excess premiums and earnings. Not all life insurance policies are eligible for correction under this procedure.[1]

Interest-Only Options

21. What are the tax consequences of leaving life insurance cash surrender values or endowment maturity proceeds with the insurer under the interest-only option?

The interest is fully taxable to the payee as it is received or credited.[2]

Under some circumstances, election of the interest option will postpone tax on the proceeds. If the option is elected *before* maturity or surrender without reservation of the right to withdraw the proceeds, the proceeds are not constructively received in the year of maturity or surrender.[3] But if the right of withdrawal is retained, the IRS apparently considers the proceeds as constructively received when they first become withdrawable.[4] (It can be argued, however, that the proceeds are not constructively received when the policyholder has a contractual right to change to another option.) If the option is elected on or after the maturity or surrender date, the proceeds are constructively received in the year of maturity or surrender. The sixty-day extension rule, applicable to the election of a life income or installment option, does not apply to an election of the interest option (see Q 52 and Q 513 for exclusion of exception).

If the proceeds are constructively received, the entire gain on the contract (if any) is taxable in the year of constructive receipt as if the proceeds had been actually received in a one sum settlement (Q 51). If the proceeds are not constructively received, the gain will be taxable to the person who ultimately receives the proceeds.[5]

Dividends

22. Are dividends payable on a participating life insurance policy taxable income?

As a general rule, all dividends paid or credited before the maturity or surrender of a contract are tax-exempt as return of investment until an amount equal to the policyholder's basis has been recovered. More specifically, when aggregate dividends plus all other amounts that

1. Rev. Proc. 2008-39, 2008-29 IRB 143, *superseding*, Rev. Proc. 2007-19, 2007-7 IRB 515, and Rev. Proc. 2001-42, 2001-2 CB 212.
2. IRC Sec. 72(j); Treas. Reg. §1.72-14(a).
3. *Frackelton v. Comm.*, 46 BTA 883 (1942), acq.; see *Fleming v. Comm.*, 241 F.2d 78 (5th Cir. 1957).
4. See Treas. Reg. §1.451-2; *Blum v. Higgins*, 150 F.2d 471 (2d Cir. 1945).
5. IRC Secs. 61(a), 691(a).

have been received tax-free under the contract exceed aggregate gross premiums, the excess is taxable income (see, however, Q 13).[1]

It is immaterial whether dividends are taken in cash, applied against current premiums, used to purchase paid-up additions, or left with the insurance company to accumulate interest. Thus, accumulated dividends are not taxable either currently or when withdrawn (but the *interest* on accumulated dividends is taxable (Q 23)) until aggregate dividends plus all other amounts that have been received tax-free under the contract exceed aggregate gross premiums. At that point, the excess is taxable income.[2] It is immaterial whether the policy is premium-paying or paid-up. However, dividends paid on life insurance policies that are classified as modified endowment contracts under IRC Section 7702A may be taxed differently (Q 13).

Dividends are considered to be a partial return of basis; hence they reduce the cost basis of the contract. This reduction in cost must be taken into account in computing gain or loss upon the sale, surrender, exchange, or lifetime maturity of a contract (Q 456).

23. Is interest earned on life insurance dividend accumulations currently taxable to the policyholder?

Yes. The interest must be included in the policyholder's gross income for the first taxable year during which it can be withdrawn, whether it actually is withdrawn or not.[3] If the interest is credited annually and is subject to withdrawal annually, it constitutes gross income to the policyholder each year as it is credited to the policyholder's account. But if the interest is withdrawable only on the anniversary date of the policy (or on some other specified date), it is gross income to the policyholder for the taxable year in which the anniversary date (or other specified date) falls.[4] The Tax Court has held that the interest can be included in the policyholder's gross income only for the first taxable year in which the taxpayer either actually or constructively receives it (the first year it is withdrawable); thus, the IRS cannot include the interest in the policyholder's gross income for a later year, even though the interest was not reported in the year it was constructively received. To tax the interest, IRS must reopen the policyholder's return for the prior year.[5]

24. What is the tax treatment of life insurance dividends when endowment maturity values or cash surrender values are paid in installments or as a life income?

In the case of life insurance cash surrender values and endowment maturity values, total excludable dividends paid or credited before the payments begin are subtracted from gross premiums to determine the net premium cost of the contract.[6] It is this net premium cost that is used in computing the portion of the payment that may be excluded from gross income

1. IRC Sec. 72(e)(5); Treas. Reg. §1.72-11(b)(1).
2. IRC Sec. 72(e)(5).
3. Treas. Reg. §1.451-2.
4. Treas. Reg. §1.61-7.
5. *Cohen v. Comm.*, 39 TC 1055 (1963), acq. 1964-1 CB 4.
6. IRC Sec. 72(c)(1).

(the *investment in the contract*). The treatment of dividends that are used to purchase paid-up additions is discussed in Q 25.

25. What are the tax results when life insurance or endowment dividends are used to purchase paid-up insurance additions?

Normally, no tax liability will arise at any time when life insurance or endowment dividends are used to purchase paid-up insurance additions. Dividends not in excess of investment in the contract are not taxable income (see, however, Q 13 with regard to modified endowment contracts), the annual increase in the cash values of the paid-up additions is not taxed to the policyholder, and death proceeds are tax-free.[1] In effect, dividends reduce the cost basis of the original amount of insurance and constitute the cost of the paid-up additions. Consequently, upon maturity, sale, or surrender during an insured's lifetime, gross premiums, including the cost of paid-up additions, are used as the cost of the insurance in computing gain upon the entire amount of proceeds, including proceeds from the additions.

The treatment of cash value increases and the death benefit of a contract subject to the definitional requirements of IRC Section 7702 will be different if the contract fails to meet certain requirements (Q 64).

26. Are dividends that are credited to a paid-up life insurance or endowment policy taxable income?

Regardless of whether a policy is premium paying or paid-up, dividends credited to an unmatured life insurance or endowment contract are taxed as discussed in Q 22.

27. If accumulated or post-mortem life insurance dividends are received by a deceased insured's beneficiary, are they taxable income to the beneficiary?

No, such dividends are not taxable income to the beneficiary. Accumulated dividends are exempt as property received by inheritance.[2] Terminal and post-mortem dividends are exempt as amounts received under a life insurance contract and paid by reason of the death of the insured.[3] Moreover, it appears that accumulated interest, if constructively received by a policyholder in a prior year, is not taxable to a beneficiary even though the policyholder neglected to report the interest (Q 73).[4]

28. When life insurance death proceeds are held under a settlement option, are excess interest dividends taxable to the beneficiary?

Yes, unless the proceeds are payable under a life income or installment option and the beneficiary is the surviving spouse of an insured who died before October 23, 1986. A surviving spouse of an insured who died before October 23, 1986, may exclude up to $1,000

1. IRC Sec. 72(e)(5); *Nesbitt v. Comm.*, 43 TC 629 (1965); IRC Sec. 101(a).
2. IRC Sec. 102.
3. IRC Sec. 101(a)(1).
4. *Cohen v. Comm.*, 39 TC 1055 (1963), acq.

annually of the interest (guaranteed and excess) received under an installment or life income option (Q 70).

Policy Loans

29. Are life insurance policy loans taxable?

A loan taken from a life insurance policy that *is not* classified as a modified endowment contract under IRC Section 7702A is not includable in income because it is not treated as a distribution under IRC Section 72.[1]

By contrast, a loan taken from a life insurance policy that *is* classified as a modified endowment contract is treated as a distribution under IRC Section 72 and is includable in income at the time received to the extent that the cash value of the contract immediately before the distribution exceeds the investment in the contract (Q 13).[2] Unless the loan is made under certain specific circumstances (Q 13), a 10 percent penalty tax is imposed on the amount of the loan that is includable in gross income.[3]

If a loan is still outstanding when a policy is surrendered or allowed to lapse, the borrowed amount becomes taxable at that time to the extent the cash value exceeds the owner's basis in the contract, as if the borrowed amount was actually received at the time of surrender or lapse and used to pay off the loan.[4] If a loan is outstanding at the time of death, the distribution of the face amount of the policy usually is reduced by the amount of the outstanding loan.

Planning Point: Because withdrawals from a life insurance policies not classified as a modified endowment contract are ordinarily not subject to income tax up to the amount of cost basis in the contract, it is typical to first take withdrawals until basis is exhausted and then take policy loans. By taking withdrawals up to basis and then by taking loans after that, amounts received from the policy during lifetime can be maximized and income taxes minimized. However, it is important that a program of withdrawals and loans be carefully monitored so as not to result in a policy lapse which could cause adverse income tax consequences as well as loss of the policy death benefit.

30. Can a life insurance policy owner take an income tax deduction for the interest he or she pays on a policy loan?

To be deductible, interest paid by a policy owner on a policy loan must meet the rules discussed below and, if applicable, the rules discussed in Q 4. However, even if the interest is deductible under those rules, the amount of the deduction may be limited depending on whether the interest is classified as personal interest, trade or business interest, investment interest, or interest taken into account in computing income or loss from passive activities. Generally, the determination is made by tracing the use to which the loan proceeds are put.[5]

1. IRC Sec. 72(e)(5).
2. IRC Sec. 72(e).
3. IRC Sec. 72(v).
4. See *Atwood v. Comm.*, TC Memo 1999-61.
5. See Temp. Treas. Reg. §1.163-8T.

Thus, interest on a loan used to pay premiums on personal life insurance may come within an exception explained in Q 4, but the deduction may not be available because personal interest is not deductible. There is little guidance as to whether interest on a loan used to buy life insurance can be considered investment interest (Q 632). Borrowing to finance business life insurance generally has not been considered incurred in connection with the borrower's trade or business (Q 4).

General Rule of Nondeductibility for Policy Loan Interest (Contracts Issued After June 8, 1997)

Generally, no deduction is allowed for any interest paid or accrued on any indebtedness with respect to life insurance policies owned by a taxpayer covering the life of any individual, or any endowment or annuity contracts owned by the taxpayer covering any individual.[1] This provision generally is effective for contracts issued after June 8, 1997, in taxable years ending after this date. For purposes of this effective date, any material increase in the death benefit or other material change in the contract will be treated as a new contract. However, in the case of a master contract, the addition of covered lives is treated as a new contract only with respect to the additional covered lives.[2]

The IRS has ruled that disallowed interest under IRC Section 264(a)(4) reduces earnings and profits for the taxable year in which the interest would have been allowable as a deduction but for its disallowance under that section. It does not further reduce earnings and profits when the death benefit is received under a life insurance contract.[3]

General Rule of Nondeductibility for Policy Loan Interest (Contracts Issued Prior to June 9, 1997)

For contracts issued prior to June 9, 1997, the general rule under IRC Section 264(a)(4) states that no deduction is allowed for any interest paid or accrued on any indebtedness with respect to life insurance policies owned by a taxpayer that covered the life of any individual who is an officer or employee of, or who is financially interested in, any trade or business carried on by the taxpayer. The same rule applies to any endowment or annuity contracts owned by a taxpayer that cover any individual.[4]

Prior to legislation enacted in 1996, there was an exception to this general rule for policies with less than $50,000 of indebtedness. However, effective for interest paid or accrued after October 13, 1995, the ability to deduct policy loan interest paid on company-owned life insurance policies with loans of less than $50,000 was eliminated.[5]

1. IRC Sec. 264(a)(4).
2. See IRC Sec. 264(f)(4)(E) for the definition of "master contract." TRA '97 Sec. 1084(d), as amended by IRSRRA '98 Sec. 6010(o)(3)(B).
3. Rev. Rul. 2009-25, 2009-38 IRB 365.
4. IRC Sec. 264(a)(4), prior to amendment by TRA '97 Sec. 1084(b)(1).
5. IRC Sec. 264(a)(4), as amended by HIPAA '96 Sec. 501(a) but before amendment by TRA '97 Sec. 1084.

31. Are there any exceptions to the rule that interest paid on a policy loan is nondeductible for key-person policies?

Yes. The general nondeductibility rule does not apply to any interest paid or accrued on any indebtedness with respect to policies or contracts covering an individual who is a "key person" to the extent that the aggregate amount of the indebtedness with respect to policies and contracts covering the individual does not exceed $50,000.[1]

A "key person" is an officer or 20 percent owner of the taxpayer. The number of persons who may be treated as key persons is limited to the greater of: (1) five individuals, or (2) the lesser of 5 percent of the total officers and employees of the taxpayer or 20 individuals. If the taxpayer is a corporation, a 20 percent owner is defined as any person who directly owns (1) 20 percent or more of the outstanding stock of the corporation or (2) stock possessing 20 percent or more of the total combined voting power of all of the corporation's stock. If the taxpayer is not a corporation, a 20 percent owner is any person who owns 20 percent or more of the capital or profits interest in the taxpayer.[2]

Generally, all members of a controlled group are treated as a single taxpayer for purposes of determining a 20 percent owner of a corporation and for applying the $50,000 limitation. This limitation is allocated among the members of a controlled group in the manner prescribed by the IRS.[3]

Interest in excess of the amount that would have been determined had the "applicable rate of interest" been used cannot be deducted. The applicable rate of interest for any month is the interest rate described as "Moody's Corporate Bond Yield Average – Monthly Average Corporates" as published by Moody's Investors Service (the Moody's Rate).[4]

The IRC also specifies the manner in which to determine the applicable rate of interest for pre-1986 contracts. For a contract purchased on or before June 20, 1986 with a fixed interest rate, the applicable rate of interest for any month is the Moody's Rate for the month in which the contract was purchased. If a contract with a variable interest rate was purchased on or before June 20, 1986, the applicable rate of interest for any month in an applicable period is the Moody's Rate for the third month preceding the first month in such period. "Applicable period" is the twelve-month period beginning on the date the policy is issued, unless the taxpayer elects a number of months (not greater than twelve) other than such twelve-month period to be its applicable period. Such an election, if made, applies to the taxpayer's first taxable year ending on or after October 13, 1995, and all subsequent taxable years.[5]

If any amount was received from a life insurance policy, or endowment or annuity contract subject to IRC Section 264(a)(4), upon the complete surrender, redemption, or maturity of the policy or contract during calendar years 1996, 1997, or 1998 or in full discharge during

1. IRC Sec. 264(e)(1).
2. IRC Sec. 264(e)(3).
3. IRC Sec. 264(e)(5)(A).
4. IRC Sec. 264(e)(2).
5. IRC Sec. 264(e)(2)(B)(ii).

these years of the obligation under the policy or contract that was in the nature of a refund of the consideration paid for the policy or contract, then the amount is includable in gross income ratably over the four-taxable-year period beginning with the taxable year the amount would have been included in income but for this provision.[1]

32. How is interest expense allocated to life insurance policy cash values?

No deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values. The portion that is allocable to unborrowed policy cash values is an amount that bears the same ratio to the interest expense as the taxpayer's average unborrowed policy cash values of life insurance policies and annuity and endowment contracts issued after June 8, 1997, bear to the sum of: (1) the average unborrowed policy cash values, in the case of the taxpayer's assets that are life insurance policies or annuity or endowment contracts, and (2) the average adjusted bases of such assets in the case of the taxpayer's assets that do not fall into this category.[2]

"Unborrowed policy cash value" is defined as the excess of the cash surrender value of a policy or contract (determined without regard to surrender charges) over the amount of any loan with respect to the policy or contract. For purposes of this provision, if the cash surrender value of a policy determined without reference to any surrender charge does not reasonably approximate its actual value, the amount taken into account is the greater of the amount of the insurance company liability or the insurance company reserve for the policy.[3]

33. Are there any exceptions to the general rule of nondeductibility of policy loan interest for unborrowed policy cash values?

There is an exception to this general rule of nondeductibility of policy loan interest expense that is allocable to unborrowed policy cash values. The exception applies to any policy or contract owned by an entity engaged in a trade or business if the policy or contract covers only one individual who, at the time first covered by the policy or contract, is: (1) a 20 percent owner of the entity, or (2) an individual who is not a 20 percent owner but who is an officer, director, or employee of the trade or business. (A 20 percent owner is defined in IRC Section 264(e)(4).) A policy or contract covering a 20 percent owner will not fail to come within this exception simply because it covers both the owner and the owner's spouse. Apparently, however, the policy will not qualify for this exception if spouses of officers, directors, or employees who are not also 20 percent owners are covered. For purposes of this rule, if coverage for each insured under a master contract (that is not a group life insurance contract) is treated as a separate contract for certain purposes, the coverage for each insured is treated as a separate contract.[4]

The exception is effective generally for contracts issued after June 8, 1997, in taxable years ending after this date. For purposes of this effective date, any material increase in the death benefit or other material change in the contract will be treated as a new contract. However, in

1. HIPAA '96, Sec. 501(d)(1).
2. IRC Sec. 264(f).
3. IRC Sec. 264(f)(3).
4. IRC Sec. 264(f)(4)(E).

the case of a master contract, the addition of covered lives is treated as a new contract only with respect to the additional covered lives.[1]

34. What are the general interest deduction rules?

Interest is deductible by a cash basis taxpayer only to the extent the taxpayer actually pays it in cash or cash equivalent in the tax year.[2] Thus, if the interest due on a policy loan is not paid but is merely deducted by the insurer from principal at the time of making the loan or merely added to loan principal, it is not currently deductible by a cash basis taxpayer.[3] Likewise, a cash basis taxpayer cannot deduct interest owing on a policy loan that is deducted by the insurer from the proceeds of a new loan with the balance being remitted to the policyholder.[4] But if interest that has been deducted from or added to the principal amount of the policy loan is later paid, it is deductible by the cash basis taxpayer when paid.[5] If the interest has been added to the loan principal, a deduction is allowable when, on maturity or surrender of the policy or on the death of the insured, the insurer deducts the accumulated interest from the proceeds.[6]

Cash basis taxpayers deduct prepaid interest over the period to which it relates, not in the year it is prepaid.[7] An accrual basis taxpayer can deduct interest in the year it accrues, regardless of whether the interest is actually paid in that year.[8]

Only the person who owns a policy when the interest accrues is entitled to the deduction. A policy owner who takes out a policy loan and later makes an absolute assignment of the policy subject to the loan is not entitled to deduct interest that accrues after the assignment. For example, if a father continues to pay interest on policy loans after giving the policy to his children, he cannot deduct payments of interest accruing after the transfer.[9] Nor can a husband deduct on a separate return the interest he pays on a policy loan when the policy is owned by his wife.[10] Similarly, a person to whom the policy has been assigned cannot pay and deduct interest that has accrued before the assignment.[11]

When a policyholder makes unspecified installment payments covering both premiums and interest, payments will be applied first toward premiums, and only the balance will be considered deductible interest.[12] Payments specified and applied as interest, however, will be treated as such.[13]

IRC Section 265(a)(2) forbids the deduction of interest on loans to purchase or carry tax-exempt investments. Borrowing to enable an insured to buy a key person policy on the insured

1. TRA '97 Sec. 1084(d), as amended by IRSRRA '98 Sec. 6010(o)(3)(B). See IRC Sec. 264(f)(4)(E) for the definition of "master contract."
2. IRC Sec. 163; Treas. Reg. §1.163-1.
3. Rev. Rul. 73-482, 1973-2 CB 44.
4. *Keith v. Comm.*, 139 F.2d 596 (2d Cir. 1944).
5. Rev. Rul. 73-482, above.
6. *Est. of Hooks v. Comm.*, 22 TC 502 (1954), acq. 1955-1 CB 5.
7. IRC Sec. 461(g).
8. *Corlett v. Comm.*, 5 T.C.M. (CCH) 94; IRC Sec. 461(h).
9. *Dean v. Comm.*, 35 TC 1083 (1961), nonacq. 1973 AOD LEXIS 238 (1973).
10. *Colston v. Burnet*, 59 F.2d 867 (DC Cir. 1932); see *Sherman v. Comm.*, 18 TC 746 (1952), nonacq. 1964-2 CB 9.
11. *Fox v. Comm.*, 43 BTA 895 (1941); see also *Orange Securities Corp. v. Comm.*, 45 BTA 24 (1941).
12. *Evans v. Comm.*, 5 TCM (CCH) 438 (1946).
13. *Kay v. Comm.*, 44 TC 660 (1965).

from the insured's employer was held sufficiently unrelated to the insured's investment in tax-exempt bonds so that interest on the loan was deductible to the extent that the tax-exempt bonds were not used as collateral for the loan.[1]

Several cases have disallowed the deduction of interest on loans that were considered "sham" transactions – that is, transactions that offered the taxpayer nothing of economic substance other than a hoped-for deduction.[2]

Annual loans against cash value to pay current premiums were not considered "sham" in *Coors v. U.S.*,[3] *Lee v. U.S.*,[4] and *Golsen v. U.S.*[5] The important factors in these cases were the following:

- There was no prepayment of interest or premiums;
- The owner needed liquidity to meet premium payments;
- Death benefits were at all times substantial;
- Policies were standard policies; and
- The loans were straightforward, ordinary, and available to any policyholder.[6]

The deduction of interest on a policy loan in each of the first three policy years and the subsequent surrender of the policy in the fourth year was not considered a sham when a change in the tax law eliminated the insured's need for the policy death benefit.[7]

In a case involving corporate owned life insurance policies, the Tax Court held that payments from the corporation to the insurance companies were not "interest" paid on policy loans but were, in fact, constructive dividends to the insured shareholders. The court noted that payment of these amounts by the corporation conferred an economic benefit on the shareholders by increasing both the policy cash values and the death benefits.[8]

Deduction of interest paid on a policy loan by a grantor trust is discussed in Q 147; the deductibility of interest on a loan under a tax-sheltered annuity is discussed in Q 3947.

35. If the beneficiary of life insurance pays the interest on a policy loan, is this a gift to the insured?

No, there is no gift to the insured, unless the insured owns the policy.[9]

1. *Levitt v. U.S.*, 517 F.2d 1339 (8th Cir. 1975).
2. *Winn-Dixie Stores, Inc. v. Comm.*, 254 F. 3d 1313, 2001-2 USTC ¶50,495 (11th Cir. 2001); *IRS v. CM Holdings, Inc.*, 2002-2 USTC ¶50,596 (3rd Cir. 2002); *American Elect. Power Co. v. U.S.*, 2003-1 USTC ¶50,416 (6th Cir. 2003).
3. 215 Ct. Cl. 840 (1978).
4. 215 Ct. Cl. 831 (1978).
5. 80-2 USTC (CCH) 9741.
6. See *Coors v. U.S.*, above.
7. *Shirar v. Comm.*, TC Memo 1987-492, *rev'd*, 916 F.2d 1414 (9th Cir. 1990).
8. *Young v. Comm.*, TC Memo 1995-379.
9. *Seligmann v. Comm.*, 9 TC 191 (1947).

Disposition: Sale or Purchase of a Contract

36. What are the income tax consequences to the owner of a life insurance or endowment contract who sells the contract, such as in a life settlement?

Until 2009, the question of whether the cost of insurance protection should be subtracted or not from the premiums paid was unsettled. A commonly held view was that the cost of insurance protection should *not* be subtracted from the premiums paid (thus decreasing the amount of taxable gain), and this view was supported by case law.[1] Conversely, in 2005 guidance, the IRS had indicated that on a sale of a life insurance policy, it would consider the basis of the contract to be the premiums paid *minus* the cost of insurance protection – thus, increasing the amount of taxable gain.[2]

In 2009, the IRS issued Revenue Ruling 2009-13 (discussed in Q 37), which provides definitive guidance to policyholders who surrender or sell their life insurance contracts in life settlement transactions.[3] Essentially, according to the revenue ruling, the basis is *not* adjusted for the cost of insurance protection when a policy is surrendered (Situation 1,), but the cost of insurance protection *is* subtracted from the premiums paid when the policy is sold (Situations 2 and 3).

37. How is gain on the surrender of a cash value life insurance policy calculated after 2008?

Revenue Ruling 2009-13 explains how to calculate the amount and character of gain upon the surrender or sale of a life insurance policy by the insured.[4] The example below illustrates the results upon surrender of a cash value policy (Situation 1). For examples illustrating the treatment of the sale of a cash value life insurance policy and the sale of a term life insurance policy, see Q 38 and Q 39.

Revenue Ruling 2009-13: Situation 1

Facts: On January 1, 2001, John Smith bought a cash value life insurance policy on his life. The named beneficiary was a member of John's family. John had the right to change the beneficiary, take out a policy loan, or surrender the policy for its cash surrender value. John surrendered the policy on June 15, 2008, for its $78,000 cash surrender value, including a $10,000 reduction for the cost of insurance protection provided by the insurer (for the period ending on or before June 15, 2008). Through that date, John paid policy premiums totaling $64,000, and did not receive any distributions from or loans against the policy's cash surrender value. John was not terminally or chronically ill on the surrender date.

Amount of income recognized. The IRS determined that the "cost recovery" exception (to the "income first" rule) applied to the non-annuity amount received by John.[5] Under that exception,

1. See the discussion titled "Pre-Revenue Ruling 2009-13," in Q 37.
2. ILM 200504001.
3. Rev. Rul. 2009-13, 2009-21 IRB 1029.
4. Rev. Rul. 2009-13, 2009-21 IRB 1029.
5. IRC Sec. 72(e)(5).

a non-annuity amount received under a life insurance contract (other than a modified endowment contract) is includable in gross income to the extent it exceeds the "investment in the contract." For this purpose, "investment in the contract" means the aggregate premiums (or other consideration paid for the contract before that date) *minus* the aggregate amount received under the contract before that date that was excludable from gross income. The IRS ruled that John must recognize $14,000 of income: $78,000 (which included a $10,000 reduction for cost of insurance) *minus* $64,000 (premiums paid).

Character of income recognized: The IRS concluded that the $14,000 was ordinary income, not capital gain. The IRS determined that the life insurance contract was a "capital asset" described in IRC Section 1221(a). However, relying on earlier guidance, the IRS reiterated that the surrender of a life insurance contract does *not* produce a capital gain,[1] and further determined that IRC Section 1234A (which applies to gains from certain terminations of capital assets) does not change this result.

38. How is gain on the sale of a cash value life insurance policy calculated after 2008?

Revenue Ruling 2009-13 explains how to calculate the amount and character of gain upon the surrender or sale of a life insurance policy by the insured.[2] The example below illustrates the results upon the sale of a cash value life insurance policy (Situation 2). For examples illustrating the results upon the surrender of a cash value policy (Situation 1) and the sale of a term life insurance policy (Situation 3), see Q 37 and Q 39.

Revenue Ruling 2009-13: Situation 2

In Situation 2, the IRS takes the position that the cost of insurance protection must be *subtracted* from the premiums paid when determining the adjusted basis in the contract.

Facts: On January 1, 2001, John Smith bought a cash value life insurance policy on his life. The named beneficiary was a member of John's family. John had the right to change the beneficiary, take out a policy loan, or surrender the policy for its cash surrender value. John sold the policy on June 15, 2008 for $80,000 to a B, a person unrelated to John and who would suffer no economic loss upon John's death. Through that date, John paid policy premiums totaling $64,000, and did not receive any distributions from or loans against the policy's cash surrender value, which, at the time, was $78,000, including a $10,000 reduction for the cost of insurance protection provided by the insurer (for the period ending on or before June 15, 2008). John was not terminally or chronically ill on the sale date.

Amount of income recognized. The IRS first stated the general rule that gain realized from the sale or other disposition of property is the excess of the amount realized over the adjusted basis for determining gain.[3] The IRS determined that the amount John realized from the sale of the life insurance policy was $80,000.[4]

1. Rev. Rul. 64-51, 1964-1 CB 322.
2. Rev. Rul. 2009-13, 2009-21 IRB 1029.
3. IRC Secs. 1001(a), 1011.
4. IRC Sec. 1001(b).

The adjusted basis for determining gain or loss is generally the cost of the property minus expenditures, receipts, losses, or other items properly chargeable to the capital account.[1] The IRS specifically pointed out that Section 72, which involves the taxation of certain proceeds of life insurance contracts, has no bearing on the determination of the basis of a life insurance policy that is sold because that section applies only to amounts received *under* the policy, which was not the case in this situation.

Next, the IRS noted the IRC's and the courts' acknowledgment that a life insurance policy – while only a single asset – may have both investment and insurance characteristics.[2]

The IRS then stated that to measure a taxpayer's gain on the sale of a life insurance policy, the basis must be *reduced* by the portion of the premium paid for the policy that has been expended for the provision of insurance before the sale.[3]

Against that backdrop, the IRS determined that John had paid premiums totaling $64,000 through the date of sale, and that $10,000 would have to be subtracted from the policy's cash surrender value as cost of insurance charges. Thus, John's adjusted basis in the policy as of the date of sale was $54,000 ($64,000 premiums paid - $10,000 expended as the cost of insurance). Accordingly, the IRS ruled that John would have to recognize $26,000 of income upon the sale of the life insurance policy, which is the excess of the amount realized on the sale ($80,000) over John's adjusted basis in the contract ($54,000).

Character of income recognized. The "substitute for ordinary income" doctrine (which essentially holds that ordinary income that has been earned but not recognized by a taxpayer cannot be converted into capital gain by a sale or exchange) was held by the IRS to be applicable in this situation. The IRS stated, however, that the doctrine is limited to the amount of income that would be recognized if a policy were *surrendered* (i.e., to the inside build-up under the policy). Thus, if the income recognized on a *sale* (or exchange) of a policy exceeds the "inside build-up" under the policy, the excess may qualify as gain from the sale or exchange of a capital asset.[4]

In Situation 2, because the "inside build-up" in John's life insurance policy was $14,000 ($78,000 cash surrender value - $64,000 aggregate premiums paid), the IRS concluded that that amount would constitute ordinary income under the doctrine. Because the policy was a capital asset (under Section 1221) and had been held by John for more than one year, the remaining $12,000 of income represented long-term capital gain.[5]

Effective date: The IRS has declared that the holding in Situation 2 will not be applied adversely to sales occurring before August 26, 2009.[6]

1. IRC Secs. 1011, 1012, 1016.
2. See IRC Sec. 7702. *London Shoe Co. v. Comm.*, 80 F.2d 230 (2nd Cir. 1935); *Century Wood Preserving Co. v. Comm.*, 69 F.2d 967 (3rd Cir. 1934).
3. *London Shoe Co. v. Comm.*, 80 F.2d 230 (2nd Cir. 1935); *Century Wood Preserving Co. v. Comm.*, 69 F.2d 967 (3rd Cir. 1934); *Keystone Consolidated Publishing Co. v. Comm.*, 26 BTA 1210, 12 (1932). See also Treas. Reg. §1.1016-2(a). But compare Rev. Rul. 2009-14, 2009-21 IRB 1031, Q 51.
4. See, e.g., *Comm. v. Phillips*, 275 F.2d 33, 36, n.3 (4th Cir 1960).
5. IRC Sec. 1222(3).
6. Rev. Rul. 2009-13, 2009-21 IRB 1029.

Planning Point: The life settlement, or seemingly any transfer for value to a party lacking insurable interest, constitutes a transaction possibly subject to income taxation. Revenue Ruling 2009-13 concludes that the policy basis is first reduced by the "cost of insurance" (COI) charges. The amount received in excess of this COI adjusted basis is ordinary income up to the policy cash surrender value. Amounts in excess of cash surrender value is capital gain.

39. How is gain on the sale of a term life insurance policy calculated after 2008?

Revenue Ruling 2009-13 explains how to calculate the amount and character of gain upon the surrender or sale of a life insurance policy by the insured.[1] The example below illustrates the results upon the sale of a term life insurance policy (Situation 3). For examples illustrating the results upon surrender of a cash value policy or the sale of a cash value policy, see Q 37 and Q 38.

Revenue Ruling 2009-13: Situation 3

In Situation 3, the IRS takes the position that the cost of insurance protection must be *subtracted* from the premiums paid.

Facts: On January 1, 2001, John Smith bought a fifteen year level premium term life insurance policy on his life. The policy had a $500 monthly premium. The named beneficiary was a member of John's family. John had the right to change the beneficiary, take out a policy loan, or surrender the policy for its cash surrender value. John paid $45,000 total premiums through June 15, 2008, at which point he sold the policy for $20,000 to a B, a person unrelated to John and who would suffer no economic loss upon John's death. John was not terminally or chronically ill on the sale date.

Amount and character of income recognized: The IRS stated that absent other proof, the cost of the insurance provided to John each month was presumed to equal the monthly premium under the policy ($500). Consequently, the cost of insurance protection provided to John during the 89.5-month period was $44,750 ($500 monthly premium times 89.5 months). Thus, John's adjusted basis in the policy on the date of sale to B was $250 ($45,000 total premiums paid – $44,750 cost of insurance protection). The IRS concluded that John was required to recognize $19,750 long-term capital gain upon the sale of the term life policy ($20,000 amount realized – $250 adjusted basis).[2]

Effective date: The IRS has declared that the holding in Situation 3 will not be applied adversely to sales occurring before August 26, 2009.[3]

40. How is gain on the sale or surrender of a life insurance policy before 2009 calculated?

Gain up to the amount of the contract's cash surrender value should be taxed to the seller as ordinary income. According to the decided cases, the amount of taxable gain is determined

1. Rev. Rul. 2009-13, 2009-21 IRB 1029.
2. IRC Sec. 1222(3).
3. Rev. Rul. 2009-13, 2009-21 IRB 1029.

in the same way as upon surrender of a contract (Q 51). In other words, gain is determined by subtracting the net premium cost (i.e., gross premiums less dividends to the extent excludable from income) from the sale price.[1] Therefore, under the decided cases, the cost of insurance protection is *not* deducted from the premiums paid. However, later guidance indicated that on a sale of a life insurance policy, the IRS considered the basis of the contract to be the premiums paid *minus* the cost of insurance protection.[2]

Before Revenue Ruling 2009-13 (see Q 38 to Q 40), the issue of whether gain in excess of the contract's cash surrender value (such as in a life settlement) is ordinary income or capital gain was unsettled. Some argued that the entire gain should be ordinary income. But others contended that gain in excess of the contract's cash surrender value should receive capital gain treatment. In support of the argument that a portion of a life settlement should be treated as a capital gain, proponents pointed to a footnote in the *Phillips* case in which the IRS conceded that in certain situations the sale of a life insurance contract might result in capital gain treatment.[3] However, in a technical advice memorandum, the IRS pointed out that even if a life insurance contract is treated as a capital asset, the entire gain from the sale of a contract should be treated as ordinary income.[4]

In another case, the Tax Court held that settlement proceeds ($500,000) received by the taxpayer (a former corporate executive) with respect to a life insurance policy represented an extinguishment of the taxpayer's claim to ownership of the policy, as opposed to a sale or exchange of a capital asset. Accordingly, the proceeds were taxable as ordinary income.[5]

41. Will the owner of a life insurance policy recognize a loss when the policy is sold for its cash surrender value?

Losses. Normally there will be no loss when a life insurance policy is sold for its cash surrender value (Q 61.)

For the treatment of amounts received from a viatical settlement provider, see Q 57.

42. What are the tax results if a life insurance policy is sold subject to a nonrecourse loan?

Loans. If a contract sold is subject to a nonrecourse loan, the transferor's obligation under the loan is discharged and the amount of the loan is considered an amount received on the transfer.[6]

For the treatment of amounts received from a viatical settlement provider, see Q 57.

1. *Gallun v. Comm.*, 327 F.2d 809 (7th Cir. 1964); *Comm. v. Phillips*, 275 F.2d 33 (4th Cir. 1960); *Est. of Crocker v. Comm.*, 37 TC 605 (1962); *Neese v. Comm.*, TC Memo 1964-288; see also *Cohen v. Comm.*, 39 TC 1055 (1963).
2. ILM 200504001.
3. *Comm. v. Phillips*, 275 F.2d 33, fn.3 (4th Cir. 1960).
4. TAM 200452033.
5. *Eckersley v. Comm.*, TC Memo 2007-282.
6. Rev. Rul. 2009-13, 2009-21 IRB 1029.

Planning Point: A life insurance policy may be exchanged for an annuity tax-free under IRC Section 1035, after which the resulting annuity must have the same basis as the original life insurance policy. See Q 44 and Q 49. The rules for recognizing a loss on the surrender of an annuity in a loss position are more liberal than those governing life insurance. See Q 491.

43. How is the purchaser of a life insurance or endowment contract taxed?

If a purchaser receives lifetime proceeds under a life insurance or endowment contract, the purchaser is generally taxed in the same way as an original owner would be taxed, but with the following differences. The purchaser's cost basis is the consideration the purchaser paid for the contract, plus any premiums the purchaser paid after the purchase, less any excludable dividends and unrepaid excludable loans received by the purchaser after the purchase.[1] It also should be noted that the purchase of a life insurance policy will, under some circumstances, result in loss of the income tax exemption for the death proceeds (see Q 264 through Q 275, "Proceeds Taxable Because Of Transfer for Value").

Revenue Ruling 2009-14

In 2009, the IRS released guidance regarding the different tax consequences for an investor (B) upon the receipt of either (1) death benefits or (2) sale proceeds with regard to a term life insurance policy that the investor purchased for profit.[2]

Situation 1 – Receipt of Death Benefits by Third Party Who Purchases Term Life Policy from Insured: John Smith is a U.S. citizen residing in the United States. B (a U.S. "person" within the meaning of Section 7701(a)(30)) purchased a fifteen-year level premium term life insurance policy on John's life for $20,000 on June 15, 2008, when the remaining term of the policy was seven years, six months, and fifteen days. B named himself beneficiary of John's policy immediately after acquiring it. B purchased the policy with a view to profit, and the likelihood that B would allow the policy to lapse was remote. B was unrelated to John, had no insurable interest in John's life, and would not suffer economic loss upon John's death. B paid monthly premiums totaling $9,000. Upon John's death (December 31, 2009), the insurance company paid $100,000 to B.

The IRS determined that the purchase of the policy by B was a transfer for value with no exception being applicable. Accordingly, the amount received because of John's death was excludable from gross income under IRC Section 101(a)(1), although under IRC Section 101(a)(2) the exclusion would be limited to the sum of the actual value of the consideration paid for the transfer ($20,000) and other amounts paid by B ($9,000), or $29,000. Therefore, the IRS ruled that B was required to recognize $71,000 of gross income, which is the difference between the total death benefit received ($100,000) and the amount excluded under IRC Section 101 ($29,000). With respect to the character of the gain, the IRS determined that neither the surrender of a life insurance or annuity contract, nor the receipt of a death benefit from the issuer under the terms of the contract, produces a capital gain. Accordingly, the IRS

1. Treas. Regs. §1.72-10(a).
2. Rev. Rul. 2009-14, 2009-21 IRB 1031.

ruled that the $71,000 of income recognized by B upon the receipt of the death benefits under the contract was ordinary income.

Situation 2 – Resale of Policy by Third Party Who Bought Term Life Policy from Insured: The facts here are the same as immediately stated above, except that: (a) John did not die; and (b) on December 31, 2009, B sold the policy to C (unrelated to John or B) for $30,000. The IRS found that in this situation, unlike Situation 2 of Revenue Ruling 2009-13 (Q 36), no reduction to basis for the cost of insurance charges was necessary because unlike John, B did not purchase the policy for protection against economic loss. The IRS therefore distinguished this situation from Revenue Ruling 2009-13 because B acquired and held the policy solely with a view to profit. Accordingly, the IRS required B to recognize only $1,000 on the sale of the life insurance policy ($30,000 – [$20,000 + $9,000]). Because the term life insurance policy was not property excluded from capital gain treatment under IRC Sections 1221(a)(1) through 1221(a)(8), and because it had been held for more than one year, the IRS characterized the $1,000 of gain recognized by B under IRC Section 1001 as long-term capital gain (citing Revenue Ruling 2009-13). In addition, because the policy was a term policy without any cash value, the substitute for ordinary income doctrine (under *U.S. v. Midland Ross*) did not apply.[1]

Disposition: Policy Exchanges

44. Does tax liability arise when a policyholder exchanges one life insurance contract for another one?

The IRC provides that the following are *nontaxable* exchanges: (1) the exchange of a life insurance policy for another life insurance policy, for an endowment or annuity contract, or for a qualified long-term-care insurance contract, (2) the exchange of an endowment contract for an annuity contract, for an endowment contract under which payments will begin no later than payments would have begun under the contract exchanged, or for a qualified long-term-care insurance contract, (3) the exchange of an annuity contract for another annuity contract or for a qualified long-term-care insurance contract, and (4) the exchange of a qualified long-term care insurance contract for another qualified long-term care insurance contract.[2] These rules do not apply to any exchange having the effect of transferring property to any non-U.S. person.[3]

If an exchange involves life insurance policies, the policies must be on the life of the same insured. Otherwise, the exchange does not qualify as a tax-free exchange under IRC Section 1035(a).[4]

Planning Point: If a policy loan is outstanding at the time of an IRC Section 1035 tax-free exchange, the amount of the *net* reduction, if any, in the taxpayer's outstanding loan will be considered "boot" and taxable as ordinary income at that time to the extent there is income on the contract, without regard to basis.

1. 381 US 54 (1965).
2. IRC Sec. 1035(a).
3. IRC Sec. 1035(c).
4. Treas. Reg. §1.1035-1.

45. Is there any tax liability when a policyholder exchanges a life insurance policy insuring one life for a policy insuring two lives?

In a private ruling, the IRS concluded that exchanges of policies insuring a single life for a policy insuring two lives do not qualify for nonrecognition treatment under IRC Section 1035. The IRS reached this outcome in all of the following situations:

(1) Spouse A exchanges a policy insuring only Spouse A's life for a policy that insures the lives of both Spouse A and Spouse B;

(2) Spouse A exchanges two life insurance policies, one of which insures Spouse A and the other of which insures Spouse B, for a single second-to-die policy insuring the lives of both Spouse A and Spouse B;

(3) Spouse A and Spouse B jointly exchange separate policies each of which insures the life of one spouse for a single jointly-owned second-to-die policy that insures the lives of both Spouse A and Spouse B;

(4) A trust owns and exchanges a policy insuring the life of Spouse A for a policy that insures the lives of both Spouse A and Spouse B; and

(5) A trust owns and exchanges two life insurance policies, one of which insures Spouse A and the other of which insures Spouse B, for a single second-to-die policy insuring the lives of both Spouse A and Spouse B.[1]

46. Is there any tax liability when a joint and last survivor policy is exchanged for a single life policy on the surviving insured?

In a private ruling, the IRS has sanctioned IRC Section 1035 treatment for the exchange of a joint and last survivor life insurance policy, following the death of one of the insured persons, for a universal variable life insurance policy that insures the survivor. The IRS noted that at the time of the exchange, both policies were insuring the same single life and that the new policy would better suit the policy owner's needs because it was less costly.[2] The IRS reached the same conclusion in another private ruling in which a second-to-die policy was exchanged after the death of one insured for a policy insuring only the survivor.[3]

47. Is there any tax liability when a whole life policy subject to indebtedness is exchanged for a new policy subject to the same indebtedness?

When a whole life policy with an outstanding loan was exchanged for another whole life policy subject to the same indebtedness, the exchange was treated as an entirely tax-free exchange.[4] The IRS reached the same conclusion when one policy was exchanged for another subject to the same indebtedness and the taxpayer contemplated making withdrawals or partial

1. Let. Rul. 9542037.
2. Let. Rul. 9248013.
3. Let. Rul. 9330040.
4. Let. Ruls. 8806058, 8604033.

surrenders from the policy to reduce the indebtedness.[1] The cost basis of the new contract will be the cost basis of the old, plus the amount of gain recognized, minus the amount of cash or other property received (with proper adjustments for premiums paid and dividends received after the exchange).[2]

Planning Point: Applying a step-transaction doctrine approach, life insurance companies typically treat loans repaid within six months (or a year) after the exchange as having been extinguished at the time of the exchange. It is important to know the reporting policy of the company issuing the new policy if a quick repayment of a carry-over loan is contemplated. But, even if not reported, extinguishment of the carry-over loan shortly after issue could be regarded by the IRS as if extinguished at issue – possibly creating taxable income.

48. Is there any tax liability when two individual policies are exchanged for two interests in a group universal life policy?

The IRS also has ruled privately that the exchange of two individual life insurance policies for two participating interests in a group universal life insurance policy qualifies as a valid IRC Section 1035(a) transfer.[3] Thus, there is no tax liability.

49. Is the exchange of life insurance policies for annuities a tax-free exchange?

The IRS has concluded that the exchange of two nonparticipating flexible premium life insurance policies, each issued by a different life insurance company, for a single nonparticipating flexible premium variable annuity contract, issued by a third life insurance company, is a proper IRC Section 1035 exchange. The IRS agreed that the annuity could be initially issued in the amount of the proceeds received from the first policy and then increased in value when the proceeds of the remaining policy arrived.[4]

When a life insurance policy was exchanged for an annuity plus an additional cash payment, the IRS concluded that the exchange qualified for IRC Section 1035 treatment. The additional cash payment into the newly-issued annuity was needed to meet the annuity's minimum premium requirement. Further, noting that administrative delays should not convert a tax-free exchange to a taxable one, the IRS concluded that if the two amounts were not received at the same time, the insurance company could issue the annuity in an amount equal to the cash payment and then later increase the value of the annuity when the funds from the life insurance policy were received.[5]

50. Does the substitution of one insured for another qualify as a tax-free exchange?

The substitution of one insured for another under an exchange-of-insureds option on a corporate-owned key person policy is treated by the IRS as a sale or other disposition under

1. Let. Rul. 8816015.
2. IRC Sec. 1031(d); Treas. Reg. §1.1031(d)-1.
3. Let. Rul. 9017062.
4. Let. Rul. 9708016.
5. Let. Rul. 9820018.

IRC Section 1001 and not as a tax-free exchange under IRC Section 1035(a).[1] The IRS determined that an insurance company's exchange of old corporate-owned life insurance contracts (modified endowment contracts (MECs) issued after June 8, 1997) for new corporate-owned contracts qualified as a tax-free exchange under IRC Section 1035 when each new contract would insure the life of the same individual who was insured under the old contract.[2] The IRS also has ruled that if a taxpayer (employer) that owns MECs issued by the same insurance company in the same calendar year exchanges some of those MECs for new MECs issued by a second insurance company, the new contracts are *not* required to be aggregated with the remaining original contracts under IRC Section 72(e)(12).[3]

The IRS has ruled that if a taxpayer receives a check from a life insurance company under a nonqualified annuity contract, the endorsement of the check to a second company, as consideration for a second annuity contract, does *not* qualify as a tax-free exchange under IRC Section 1035(a)(3). Instead, the amount received by the taxpayer is taxed on an income-first basis under IRC Section 72(e).[4]

See Q 19 for a discussion of the effect of an IRC Section 1035 exchange on the grandfathered status of a policy issued prior to June 21, 1988, and thus not subject to the seven pay test of IRC Section 7702A.

Disposition: Surrender, Redemption, or Maturity

51. What are the income tax consequences when the owner of a life insurance or endowment contract takes the lifetime maturity proceeds or cash surrender value in a one sum cash payment?

Amounts received on complete surrender, redemption, or maturity of a life insurance or endowment contract are taxed under the cost recovery rule (Q 10). If the maturity proceeds or cash surrender value exceeds the cost of the contract, the excess is taxable income in the year of maturity or surrender, even if the proceeds are not received until a later tax year.[5] (For computation of "cost," see Q 456.) The gain is ordinary income, not capital gain.[6]

The IRC provides that aggregate premiums are the investment in the contract, which is used for computing *gain* upon the lifetime maturity or surrender of a life insurance or endowment contract (Q 456).[7] Consequently, although the portion of the premiums paid for current life insurance protection is generally a nondeductible personal expense, that portion nevertheless may be included in the investment in the contract for the purpose of computing gain upon the surrender or lifetime maturity of the policy.

1. Rev. Rul. 90-109, 1990-2 CB 191.
2. Let. Rul. 200711014. See also Let. Rul. 200801001.
3. Rev. Rul. 2007-38, 2007-25 IRB 1420.
4. Rev. Rul. 2007-24, 2007-21 IRB 1282.
5. See *Kappel v. U.S.*, 369 F. Supp. 267 (W.D. Pa. 1974).
6. IRC Sec. 72(e); Treas. Reg. §1.72-11(d).
7. IRC Sec. 72(e)(6).

> *Example*. Mr. Green purchases a whole life policy in the face amount of $100,000. He uses dividends to purchase paid-up additions. Over a twenty-year period, gross premiums amount to $47,180. Of this amount, $13,018 represents the net protection portion of the premiums, and $34,162 the investment portion. At the end of the twenty-year period, Mr. Green surrenders his policy for its cash surrender value of $48,258 (cash value of the original $100,000 policy plus cash value of insurance additions). His investment in the contract is $47,180 (not $47,180 less $13,018). Thus, his taxable gain is $1,078 ($48,258 – $47,180), not $14,096 ($48,258 – $34,162).

In a 2009 Revenue Ruling, the IRS reiterated the above conclusion, ruling that a policy owner who surrenders a policy in a life settlement transaction is not required to subtract the cost of insurance charge from the policy owner's investment in the contract. In the revenue ruling, the cash surrender value of the subject policy was $78,000 (the IRS assumed that the cash surrender value already reflected the subtraction of the cost of insurance protection ($10,000)). The amount of premiums paid was $64,000. According to the IRS, the taxpayer's recognized gain was only $14,000 ($78,000 surrender proceeds - $64,000 investment in the contract), all of which was declared ordinary income by the IRS.[1] (For a more detailed analysis, see Situation 1, "Surrender of Cash Value Policy," in 37.01.)

With respect to a viatical settlement, however, the IRS has ruled privately that at the time of the assignment to a viatical settlement company, the *basis* of a whole life policy was equal to premiums paid *less* the sum of the cost of insurance protection provided up to the assignment date and any amounts, such as dividends, that were received under the contract but were not included in gross income. The cost of insurance protection in the private letter ruling was found to equal the aggregate premiums paid less the cash value of the policy. This ruling implies that, at least according to the IRS, the terms "basis" and "investment in the contract" do not mean the same thing.[2]

For a discussion of the exception to the general rule that gain on endowment maturities and cash surrenders is taxable income, see Q 134 on government life insurance.

52. If a life insurance policyholder elects to receive endowment maturity proceeds or cash surrender values under a life income or installment option, is the gain on the policy taxable to the policyholder in the year of maturity or in the year of surrender?

Ordinarily, a cash basis taxpayer is treated as having *constructively received* an amount of cash when it first becomes available to the taxpayer without substantial limitations or restrictions. The taxpayer must report this amount as taxable income even though the taxpayer has not actually received it.[3] When an endowment contract matures, or any type of contract is surrendered, a lump-sum payment generally becomes available to the policyholder unless, *before* the maturity or surrender date, the taxpayer has elected to postpone receipt of the proceeds under a settlement option. For an exception to this general rule, see Q 513.

1. Rev. Rul. 2009-13, 2009-21 IRB 1029.
2. Let. Rul. 9443020.
3. Treas. Reg. §1.451-2.

53. Can tax on the gain at maturity of an endowment contract be postponed?

Yes.

With an election to have proceeds paid under an installment or life income option, the gain can be spread over a fixed period of years or over the payee's lifetime (Q 52). Tax on the gain also may be postponed by electing the interest-only option before maturity and retaining no withdrawal rights (Q 21).

Another method to postpone the gain appears to be a situation in which the endowment is exchanged before maturity for a deferred annuity (Q 44, Q 495). The IRS has ruled that the exchange of an endowment for an annuity is a tax-free exchange.[1]

Some contracts provide that the owner may elect to continue the contract in force to an optional maturity date. If the contract so provides, and the election is made before the original maturity date, the owner should not be in constructive receipt of the gain under the policy before the optional maturity date. There are no specific rulings on this, however.

See also Q 64 with respect to contracts subject to the definitional rules of IRC Section 7702.

Accelerated Death Benefit

54. What is the income tax treatment of an accelerated death benefit payment from a life insurance contract?

Generally, any amount received under a life insurance contract on the life of a terminally ill insured or a chronically ill insured will be treated as an amount paid by reason of the death of the insured.[2] Amounts received under a life insurance contract by reason of the death of the insured are not includable in gross income.[3] See Q 62. Thus, an accelerated death benefit meeting these requirements will generally be received free of income tax.

However, amounts paid to a chronically ill individual are subject to the same limitations that apply to long-term-care benefits. Generally, this is a limitation of the amount of benefits per day ($330 in 2014).[4] See Q 434. More specifically, if the total periodic long-term-care payments received from all policies and any periodic payments received that are treated as paid by reason of the death of the insured (under IRC Section 101(g)) exceed a per-diem limitation, the excess must be included in income (without regard to IRC Section 72). (If the insured is terminally ill when a payment treated under IRC Section 101(g) is received, the payment is not taken into account for this purpose.)[5]

The per-diem limitation is equal to the greater of (1) a $330 per day limitation in 2014 or (2) the actual costs incurred for qualified long-term-care services provided for the insured less

1. Rev. Rul. 72-358, 1972-2 CB 473; Rev. Rul. 68-235, 1968-1 CB 360.
2. IRC Sec. 101(g)(1).
3. IRC Sec. 101(a).
4. IRC Secs. 101(g)(3)(D), 7702B(d).
5. IRC Sec. 7702B(d)(1).

any payments received as *reimbursement* for qualified long-term-care services for the insured.[1] This figure is adjusted for inflation annually.[2] Accelerated death benefits paid to terminally ill individuals are not subject to this limit.

> *Example*. In 2014, Mr. Heller received qualified long-term-care services for 30 days at a total cost of $7,500. A qualified long-term-care insurance contract paid him a benefit of $330 per day, $9,900 total. In addition, $500 of the cost of the qualified long-term-care services was reimbursed by another source. Thus, $500 of the $9,900 benefit is includable in income by Mr. Heller.

A terminally ill individual is a person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within twenty-four months following the certification.[3]

A chronically ill individual is a person who is not terminally ill and who has been certified by a licensed health care practitioner as unable to perform, without substantial assistance, at least two activities of daily living (ADLs) for at least ninety days or a person with a similar level of disability. Further, a person may be considered chronically ill if he requires substantial supervision to protect himself from threats to his health and safety due to a severe cognitive impairment and this condition has been certified by a healthcare practitioner within the previous twelve months.[4] See Q 424. The ADLs are: (1) eating; (2) toileting; (3) transferring; (4) bathing; (5) dressing; and (6) continence.[5]

55. Are there any special rules that apply to chronically ill insureds?

There are several special rules that apply to chronically ill insureds. Generally, the tax treatment outlined in Q 54 will not apply to any payment received for any period unless the payment is for costs incurred by the payee (who has not been compensated by insurance or otherwise) for qualified long-term-care services provided to the insured for the period. Additionally, the terms of the contract under which the payments are made must comply with: (1) the requirements of IRC Section 7702B(b)(1)(B); (2) the requirements of IRC Sections 7702B(g) and 4980C that the Secretary specifies as applying to such a purchase, assignment, or other arrangement; (3) standards adopted by the National Association of Insurance Commissioners (NAIC) that apply specifically to chronically ill insureds (if such standards are adopted, similar standards under number (2) above cease to apply); and (4) standards adopted by the state in which the policyholder resides (if such standards are adopted, the analogous requirements under number (2) and, subject to IRC Section 4980C(f), standards under number (3) above cease to apply).[6]

"Qualified long-term-care services" are defined as "… necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services, which…" are required by a chronically ill individual and are provided under a plan of care set forth by a licensed healthcare practitioner.[7]

1. IRC Sec. 7702B(d)(2); Rev. Proc. 2009-50, 2008-45 IRB 617, as modified by Rev. Proc. 2010-47, 2010-2 CB 827.
2. IRC Secs. 7702B(d)(4), 7702B(d)(5).
3. IRC Sec. 101(g)(4)(A).
4. IRC Secs. 101(g)(4)(B), 7702B(c)(2)(A).
5. IRC Sec. 7702B(c)(2)(B).
6. IRC Sec. 101(g)(3)(B).
7. IRC Sec. 101(g)(4)(C); IRC Sec. 7702B(c)(1).

56. Are there any exceptions to the general rule of non-includability for accelerated death benefits?

There is one exception to this general rule of non-includability for accelerated death benefits. Accelerated death benefits paid to any taxpayer other than the insured if the taxpayer has an insurable interest in the life of the insured because the insured is a director, officer, or employee of the taxpayer or if the insured is financially interested in any trade or business of the taxpayer are exceptions from the special treatment afforded to payment of certain accelerated death benefits (see Q 54 and Q 55).[1]

Viatical Settlement

57. What is the income tax treatment of an amount received from a viatical settlement provider?

A viatical settlement provider is "any person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of insureds" who are terminally or chronically ill, provided that certain licensing and other requirements are met.[2] To be considered a viatical settlement provider a person must be licensed for such purposes in the state in which the insured resides. The IRS has provided guidance on when viatical settlement providers will be considered licensed.[3]

If any portion of a death benefit under a life insurance contract on the life of a terminally or chronically ill insured is sold or assigned to a viatical settlement provider, the amount paid for the sale or assignment will be treated as an amount paid under the life insurance contract by reason of the insured's death.[4] In other words, such an amount will not be includable in income (Q 62).[5]

A terminally ill individual is a person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within twenty-four months following the certification.[6]

A chronically ill individual is a person who is not terminally ill and who has been certified by a licensed healthcare practitioner as being unable to perform, without substantial assistance, at least two activities of daily living (ADLs) for at least ninety days or a person with a similar level of disability. Further, a person may be considered chronically ill if the person requires substantial supervision to protect himself or herself from threats to his or her health and safety due to severe cognitive impairment and this condition has been certified by a healthcare practitioner within the previous twelve months.[7] See Q 424. The activities of daily living are:

(1) eating;

(2) toileting;

1. IRC Sec. 101(g)(5).
2. IRC Sec. 101(g)(2)(B)(i).
3. Rev. Rul. 2002-82, 2002-2 CB 978.
4. IRC Sec. 101(g)(2)(A).
5. See IRC Sec. 101(a).
6. IRC Sec. 101(g)(4)(A).
7. IRC Secs. 101(g)(4)(B), 7702B(c)(2)(A).

(3) transferring;

(4) bathing;

(5) dressing; and

(6) continence.[1]

If an insured resides in a state that does not require licensing of viatical settlement providers, the insured must meet the standards for either a terminally ill individual or a chronically ill individual.[2] The requirements applicable to an insured who is a terminally ill individual are met if the person: (1) meets the requirements of Sections 8 and 9 of the Viatical Settlements Model Act of the NAIC, and (2) meets the requirements of the Model Regulations of the NAIC in determining amounts paid by such person in connection with such purchases or assignments.[3] The requirements applicable to an insured who is a chronically ill individual are met if the person: (1) meets requirements similar to the requirements of Sections 8 and 9 of the Viatical Settlements Model Act of the NAIC, and (2) meets the standards of the NAIC for evaluating the reasonableness of amounts paid by such person in connection with such purchases or assignments with respect to chronically ill individuals.[4]

Planning Point: The term "viatical settlement" is technical in its definition that viatical settlements refer to only those cases where the insured under the policy is terminally ill. Where the insured is not terminally ill, the terminology of "high net worth transactions" or "senior settlements" may be more appropriate. Transactions involving senior settlements, rather than "viatical settlements" are not necessarily taxed in the same manner.

58. Are there special rules regarding the income tax treatment of an amount received by a chronically ill insured from a viatical settlement provider?

There are several special rules that apply to chronically ill insureds. Generally, the tax treatment outlined above will not apply to any payment received for any period unless such payment is for costs incurred by the payee (who has not been compensated by insurance or otherwise) for qualified long-term-care services provided to the insured for the period. Additionally, the terms of the contract under which such payments are made must comply with:

(1) the requirements of IRC Section 7702B(b)(1)(B) (defining "long-term care contract");

(2) the requirements of IRC Sections 7702B(g) and 4980C (Q 424) that the IRS specifies as applying to such a purchase, assignment, or other arrangement(relating to consumer protection provisions);

(3) standards adopted by the NAIC that apply specifically to chronically ill insureds (if such standards are adopted, similar standards under number (2) above cease to apply); and

1. IRC Sec. 7702B(c)(2)(B).
2. IRC Sec. 101(g)(2)(B).
3. IRC Sec. 101(g)(2)(B)(ii).
4. IRC Sec. 101(g)(2)(B)(iii).

(4) standards adopted by the state in which the policyholder resides (if such standards are adopted, the analogous requirements under number (2) and, subject to IRC Section 4980C(f), standards under number (3) above cease to apply).[1]

59. Are there any exceptions to the general rule that viatical settlements are not included as taxable income?

There is one exception to this general rule of non-includability for viatical settlements. The rules outlined above do not apply to any amount paid to any taxpayer other than the insured if the taxpayer has an insurable interest in the life of the insured because the insured is a director, officer or employee of the taxpayer or if the insured is financially interested in any trade or business of the taxpayer.[2]

Withholding

60. Are amounts received as living proceeds of life insurance and endowment contracts subject to withholding?

Yes.

A payee, however, generally may elect not to have anything withheld. Only the amount that it is reasonable to believe is includable in income is subject to withholding. Amounts are to be withheld from periodic payments at the same rate as wages. Payments are periodic, even if they are variable, if they are payable over a period of more than a year. If payments are not periodic, 10 percent of the includable amount is withheld. Payments to a beneficiary of a deceased payee are subject to withholding under the same rules.[3] An election out of withholding will be ineffective, generally, if a payee does not furnish his or her taxpayer identification number (TIN, usually the payee's Social Security number) to the payor, or furnishes an incorrect TIN to the payor and the payor is so notified by the IRS.[4]

Loss

61. Does the surrender or sale of a life insurance or endowment contract ever result in a deductible loss?

A loss deduction can be claimed only if the loss is incurred in connection with the taxpayer's trade or business or in a transaction entered into for profit.[5] If the surrendered contract is a life insurance policy, ordinarily there will be no deductible loss, even though the cash surrender value is less than the net premium cost. The IRC expressly provides that a taxpayer's investment in the contract is the "aggregate premiums paid," but this may be different than the contract's "basis" (Q 37, Q 51). The IRC, however, is silent with respect to cost basis for computing loss. Several courts have held that the portion of the premiums paid for life insurance protection cannot be included in the cost basis. They reason that this portion is not a recoverable investment, but a

1. IRC Sec. 101(g)(3)(B).
2. IRC Sec. 101(g)(5).
3. IRC Sec. 3405; Temp. Treas. Reg. §35.3405-1T (A-9, A-10, A-12, A-17, F-19 through 24).
4. IRC Sec. 3405(e)(12).
5. IRC Sec. 165.

nondeductible expense.[1] There can be no loss, therefore, if the cash surrender value equals the policy reserve. But if the contract is surrendered in a policy year in which the reserve exceeds the cash surrender value, the difference *may* be allowable as a loss, provided the policy was purchased in connection with the taxpayer's trade or business or in a transaction entered into for profit.[2] Apparently the Tax Court considers the purchase of a personal cash value policy as a transaction entered into for profit to the extent of the policy's investment feature.[3] A Texas district court, however, does not consider it a transaction for profit even to this extent.[4]

A different situation exists where, because of the insurance company's insolvency, the policy owner receives less than the stated cash surrender value. In this case, the difference between the amount received and the stated cash surrender value is a deductible loss.[5]

Death Proceeds

In General

62. Are life insurance proceeds payable by reason of the insured's death taxable income to the beneficiary?

No. As a general rule, death proceeds are excludable from the beneficiary's gross income.[6] Death proceeds from single premium, periodic premium, or flexible premium policies are received income tax-free by the beneficiary regardless of whether the beneficiary is an individual, a corporation, a partnership, a trustee, or the insured's estate.[7] With some exceptions (as noted below), the exclusion generally applies regardless of who paid the premiums or who owned the policy.

Note that death proceeds from certain employer-owned life insurance contracts will not be excluded from income unless certain requirements are met (Q 263).[8]

Planning Point: When presenting a key person proposal it is important to ask the prospect, "How much additional gross sales would it take to equal the income-tax-free benefits of life insurance?" Also point out that the sales revenue will be needed at a time when the business has lost a person critical to the creation of that revenue. *William H. Alley, CLU, ChFC, MSFS, LUTCF, Alley Financial Group, LLC.*

Proceeds from group life insurance can qualify for the exclusion as well as proceeds from individual policies. Under certain conditions, accelerated death benefits paid prior to the death of a chronically or terminally ill insured may qualify for this exclusion (Q 54). On the other hand, death benefits under annuity contracts do not qualify for the exclusion because they are not proceeds of life insurance within the meaning of IRC Section 101(a)(1).

1. *London Shoe Co., Inc. v. Comm.*, 80 F.2d 230 (2nd Cir. 1935); *Century Wood Preserving Co. v. Comm.*, 69 F.2d 967 (3rd Cir. 1934); *Keystone Consol. Publishing Co. v. Comm.*, 26 BTA 1210 (1932).
2. See *London Shoe Co., Inc.*, supra.
3. *Cohen v. Comm.*, 44 BTA 709 (1941); *Fleming v. Comm.*, 4 TCM (CCH) 316 (1945).
4. *Arnold v. U.S.*, 180 F. Supp. 746 (N.D. Texas 1959).
5. *Cohen*, supra; *Fleming*, supra.
6. IRC Sec. 101(a)(1).
7. Treas. Reg. §1.101-1(a)(1).
8. IRC Sec. 101(j).

In order to come within the exclusion, the proceeds must be paid "by reason of the death of the insured." In other words, the exclusion applies only to proceeds that are payable because the insured's death has matured the policy. When the policy has matured during the insured's lifetime, amounts payable to the beneficiary, even though payable at the insured's death, are not "death proceeds." Proceeds paid on a policy covering a missing-in-action member of the uniformed services were excludable, even though no official finding of death had been made by the Defense Department.[1]

If death proceeds are paid under a life insurance contract (as defined in by IRC Section 7702 and discussed in Q 64), the exclusion extends to the full amount of the policy proceeds. For example, if an insured dies after having paid $6,000 in premiums on a $100,000 policy, the full face amount of $100,000 is excludable from the beneficiary's gross income (not just the $6,000 that represents a return of premiums). The face amount of paid-up additional insurance and the lump sum payable under a double indemnity provision also are excludable under IRC Section 101(a)(1). When the death proceeds are received in a one sum cash payment, the entire amount is received income tax-free. However, the exclusion does not extend to interest earned on the proceeds after the insured's death. Thus, if the proceeds are held by the insurer at interest, the interest is taxable (Q 69). If the proceeds are held by the insurer under a life income or other installment option, the tax-exempt proceeds are prorated over the payment period, and the balance of each payment is taxable income (Q 70).

Generally, in the case of a contract issued after 1984 that is a life insurance contract under applicable law but that does not meet the definitional requirements explained in Q 64, only the excess of the death benefit over the net surrender value (cash surrender value less any surrender charges) will be excludable from the income of the beneficiary as a death benefit.[2] Generally, the exclusion is similarly limited to the amount of the death benefit in excess of the net surrender value in the case of a flexible premium contract that is subject to, but fails to meet, the guidelines of IRC Section 101(f) (Q 64). Nevertheless, in either case, a part of the cash surrender value also will be excludable as a recovery of basis to the extent the basis has not been previously recovered; presumably, when a contract subject to the definition of a life insurance contract in IRC Section 7702 fails to meet that definition, or when a variable contract is not adequately diversified, unrecovered cash value increases previously includable in income will be recoverable tax-free as a part of basis.

In addition, all or part of the proceeds may be taxable income in the following circumstances:

- In some instances, the policy or an interest in the policy has been transferred for valuable consideration (Q 72, Q 264);
- The proceeds are received under a qualified pension or profit-sharing plan (Q 3864);

1. Rev. Rul. 78-372, 1978-2 CB 93.
2. IRC Sec. 7702(g)(2).

- The proceeds are received under a tax-sheltered annuity for an employee of a tax-exempt organization or public school (Q 3930);
- The proceeds are received under an individual retirement endowment contract (Q 3627);
- The proceeds are received by a creditor with no other insurable interest from insurance on the life of the debtor (Q 130, Q 131);
- There is no insurable interest in the life of the insured (Q 277);
- The proceeds are received as corporate dividends or compensation (Q 276);
- The proceeds are received as alimony by a divorced spouse (Q 101);
- The proceeds are received as restitution of embezzled funds (Q 278); and
- Proceeds received by a corporation may be subject to an alternative minimum tax (Q 300).

63. Is the death benefit under the double indemnity clause of a life insurance policy subject to federal income tax?

No. The death benefit is generally tax-exempt as proceeds payable by reason of an insured's death.[1] If the proceeds are held under a settlement option, the regular rules apply (Q 69, Q 70).

64. What is a "life insurance contract" for purposes of the death benefit exclusion for contracts issued after December 31, 1984?

Under IRC Section 7702, for death proceeds of a life insurance contract (including an endowment contract) issued after December 31, 1984, to be fully excludable from the beneficiary's gross income, the contract generally must be a life insurance contract under applicable state (or applicable local foreign) law *and* must meet one of two alternative tests: the cash value accumulation test (Q 65) or the guideline premium and corridor test (Q 66).[2] Any plan or arrangement provided by a church or a convention or association of churches to its employees or their beneficiaries that provides for the payment of a death benefit is not required to meet the requirement that the arrangement constitute a life insurance contract under applicable law.[3]

The IRS may waive an insurer's failure to satisfy the requirements of IRC Section 7702(a) if the errors were reasonable and reasonable steps to remedy the errors have been taken.[4] For example, when six life insurance policies were temporarily out of compliance with the guideline premium test requirements due to the inadvertence of the insurer's employees during a change

1. IRC Sec. 101(a); Treas. Reg. §1.101-1(a)(1).
2. IRC Sec. 7702(a).
3. IRC Sec. 7702(j).
4. IRC Sec. 7702(f)(8).

in computer systems, the IRS granted such a waiver after the insurer increased the policy death benefits.[1] When a combination of clerical errors (including lost records, missed testing dates, and the failure to make scheduled premium adjustments) and the conversion of the insurance company's policy administration system from a manual procedure to a fully computerized one caused policies to be out of compliance, the IRS granted a waiver, but required that the policies be brought into compliance within ninety days.[2] When a clerk failed to realize that a certificate holder had paid in additional premiums that put a group universal life certificate out of compliance, the IRS granted a waiver provided that the company refund the excess premiums, with interest, or increase the policy death benefit from the time of noncompliance.[3] The IRS refused to waive an insurer's failure to satisfy these requirements, however, when several policies were discovered to be out of compliance due to the company's use of a software program that contained an "inherent structural flaw."[4]

Modification of a life insurance contract after December 31, 1990, that is necessitated by the insurer's insolvency will not affect the date on which the contract was issued, entered into, or purchased for purposes of IRC Section 7702.[5]

65. How is the cash value accumulation test met?

To satisfy the cash value accumulation test, the cash surrender value of a contract, according to its terms, must not at any time exceed the net single premium that would be necessary at such time to fund future benefits (death benefits, endowment benefits, and charges for certain additional benefits, such as a disability waiver) under the contract.[6] The *cash surrender value* of a contract is its cash value, disregarding any surrender charges, policy loans, or reasonable termination benefits. The *net single premium* is determined by using (1) an annual effective interest rate of 4 percent or the interest rate(s) guaranteed in the contract, whichever is greater, (2) the mortality charges specified in the contract or if none are specified, the charges used in figuring the statutory reserves for the contract, and (3) any other charges specified in the contract.

For contracts issued on or after October 21, 1988, the mortality charges used must be reasonable charges that meet the requirements, if any, identified in the applicable regulations and that do not exceed the mortality charges specified in the "prevailing commissioners' standard tables" at the time the contract is issued.[7] The exercise of an option to change a policy's death benefit after October 21, 1988, added to the policy by endorsement prior to this date, did not cause the policy to become subject to the reasonable mortality requirements of IRC Section 7702(c)(3)(B)(i), as amended by Technical and Miscellaneous Revenue Act (TAMRA).[8]

1. Let. Rul. 9042039. See also Let. Ruls. 9801042, 9727025, 9621016.
2. Let. Rul. 9416017. See also Let. Ruls. 200006030, 199924028, 9834020, 9838014.
3. Let. Rul. 9623068. See also Let. Ruls. 200027030, 9805010, 9601039, 9517042, 9322023, 9146016, 9146011.
4. Let. Rul. 9202008.
5. Rev. Proc. 92-57, 1992-2 CB 410; Let. Rul. 9239026. See also Let. Rul. 9305013.
6. IRC Sec. 7702(b).
7. IRC Sec. 7702(c)(3)(B)(i). The prevailing commissioners' standard tables are defined in IRC Section 807(d)(5). See, also, 2001 CSO Table.
8. Let. Rul. 9853033.

Proposed regulations provide three safe harbors for meeting the reasonable mortality charge requirement in contracts that insure only one life and that are entered into on or after October 21, 1988.[1] A contract issued before October 21, 1988 will meet the reasonable mortality charge requirements if it has mortality charges that do not differ materially from the charges actually expected to be made.[2] Any other reasonable charges taken into account for purposes of determining the net single premium must be reasonably expected to actually be paid and must be actually specified in the contract.[3]

66. How is the guideline premium and cash value corridor test met?

To meet the guideline premium and cash corridor test, the contract must first meet certain guideline premium requirements and, second, the contract must fall within the *cash value corridor*.

For the contract to meet the *guideline premium requirement*, the sum of the premiums paid under the contract must not at any time exceed *the greater of* (1) the guideline single premium as of such time, or (2) the sum of the guideline level premiums to such date.[4]

Premiums paid for purposes of this section means those paid under the contract less excludable amounts that are not received as an annuity under IRC Section 72(e) (e.g., dividends).[5]

The *guideline single premium* is the premium necessary to fund future benefits under the contract, determined at the time the contract is issued using the same factors as for the net single premium (Q 65), except that the annual effective rate of interest is 6 percent instead of 4 percent.[6]

The *guideline level premium* is the level annual amount payable over a period not ending before the insured reaches age ninety-five, computed in the same manner as the single guideline premium, except the annual effective rate remains at the greater of 4 percent or the rate guaranteed in the contract.[7] The IRC sets forth certain rules for computing the guideline premiums and benefits and provides special rules that, in limited circumstances, make exceptions for failing to meet the guideline premium requirements or allow premiums paid to be returned at the end of the year to correct such failures.[8]

A contract falls within the *cash value corridor* if the death benefit payable under the contract at any time is at least equal to an applicable percentage of the cash surrender value (see table below).

1. Prop. Treas. Reg. §1.7702-1.
2. TAMRA '88 Sec. 5011(c).
3. IRC Sec. 7702(c)(3)(B)(ii).
4. IRC Sec. 7702(c).
5. IRC Sec. 7702(f)(1).
6. IRC Sec. 7702(c)(3).
7. IRC Sec. 7702(c).
8. IRC Sec. 7702(f)(1)(B).

Table

In the case of an insured with an attained age as of the beginning of the contract year of:		The applicable percentage decreases by a ratable portion for each full year:	
More than	**But not more than**	**From**	**To**
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

The determination of whether a variable life insurance contract meets either the cash value accumulation test (Q 65) or the guideline premium cash corridor test must be made whenever the death benefit under the contract changes, but at least once during each twelve-month period.[1]

Planning Point: Generally, use of the guideline premium test will provide higher policy cash values than the cash value corridor test when cash accumulation is the primary purpose of the policy. However, it is advisable to run the product illustration using both tests to optimize the product design.

A variable life insurance contract will not be treated as a life insurance contract, and taxed accordingly, for any period that the underlying investments of the segregated asset account are not "adequately diversified" (Q 478).[2]

The IRS has ruled that sub-accounts within variable life policies that were invested in hedge funds available to the general public would be considered owned by the policy owners, and thus currently taxed on the income.[3] Sub-accounts within a variable life contract may invest in mutual funds that are available to the general public.[4] The IRS has clarified what is meant by the phrase "general public."[5]

In Rev. Proc. 2010-28, the IRS provides a safe harbor addressing the application of IRC Sections 7702 and 7702A to life insurance contracts that mature after the insured individual reaches age 100. The Revenue Procedure also addresses the treatment of amounts received under

1. IRC Sec. 7702(h)(9).
2. IRC Sec. 817(h).
3. Rev. Rul. 2003-92, 2003-33 IRB 350.
4. Let. Rul. 200420017.
5. Rev. Rul. 2007-7, 2007-7 IRB 468.

a life insurance contract after it has matured. Under the safe harbor, the IRS will not challenge the qualification of a contract as a life insurance contract under IRC Section 7702, or assert that a contract is a modified endowment contract under IRC Section 7702A (Q 13), provided that the contract satisfies the requirements of those provisions using all of the Age 100 Testing Methodologies in Section 3.02 of Rev. Proc. 2010-28.[1]

Contracts issued after June 30, 1984, that provide an increasing death benefit and have premium funding more rapid than ten-year level premium payments must satisfy the definition generally applicable to contracts issued after 1984, with certain exceptions.[2]

67. What is a "life insurance contract" for purposes of the death benefit exclusion for policies issued before January 1, 1985?

A policy issued before January 1, 1985, that is exchanged for one issued after December 31, 1984, will be treated as a contract issued after 1984 and subject to the definitional requirements of IRC Section 7702 discussed in Q 64, according to the General Explanation of the Deficit Reduction Act of 1984 (the General Explanation). The General Explanation states that a change in policy terms after December 31, 1984, could be considered an exchange that would bring the policy under the IRC Section 7702 definitional requirements. Examples of "changes in terms" are changes in "amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges."[3] A change in minor administrative provisions or a loan rate change generally would not be considered to result in an exchange, the General Explanation adds. Modification of a life insurance contract after December 31, 1990, that is made necessary by the insurer's insolvency will not affect the date on which the contract was issued, entered into, or purchased for purposes of IRC Section 101(f).[4]

Otherwise, universal life insurance and any other flexible premium contract, issued before January 1, 1985, qualify for the death proceeds exclusion only if (1) the sum of the premiums does not exceed at any time a guideline premium (see below) *and* the death benefit is not less than a certain percentage of the cash value (140 percent until the start of the policy year the insured attains age forty, thereafter reducing 1 percent for each year over forty, but not below 105 percent) *or* (2) the contract provides that the cash value may not at any time exceed the net single premium for the death benefit at that time.

The guideline premium is the greater of (1) the single premium necessary to fund future benefits under the contract based on the maximum mortality rates and other charges fixed in the contract and the minimum interest rate guaranteed in the contract at issue, but at least 6 percent, or (2) the aggregate level annual amounts payable over the life of the contract (at least twenty years but not extending beyond age ninety-five, if earlier) computed in the same manner as the single premium guideline (using an annual effective rate of 4 percent instead of 6 percent). The IRS can allow excessive premiums paid in error to be returned (with interest) within sixty days after the end of the policy year; in such case, the policy will still qualify as life insurance.[5]

1. Rev. Proc. 2010-28; 2010-2 C.B. 270.
2. DEFRA Sec. 221(d)(2).
3. General Explanation of the Deficit Reduction Act of 1984 at p. 656.
4. Rev. Proc. 92-57, 1992-2 CB 410; Let. Rul. 9239026.
5. IRC Sec. 101(f).

The death benefit of a flexible premium contract entered into before January 1, 1983, will be excludable if the contract met the requirements on September 3, 1983. In determining if the level annual premium guideline is met by such a contract, an annual effective interest rate of 3 percent may be substituted for 4 percent.[1]

For life insurance contracts (other than flexible premium contracts) issued before January 1, 1985, there is no clear definition of "life insurance" for purposes of the tax-free death benefit. Despite this, the death proceeds are not considered proceeds of life insurance unless the contract under which they are paid provided protection against the risk of early death. The IRS has taken the position that, for income tax purposes, a contract is a life insurance contract if it contained an element of life insurance risk at any time.[2] Thus, the IRS apparently has not attempted to tax the proceeds of a retirement income contract, even when the insured's death has occurred after the cash value has exceeded the face amount but before the maturity of the contract. This ruling involved a contract purchased by a qualified retirement plan and the IRS could attempt to limit its position to such contracts.[3] On the other hand, the Tax Court has held that a retirement income contract is an annuity contract once the element of risk has disappeared.[4] The IRS also has ruled that the exclusion applies to variable life insurance death benefits that may increase or decrease, but not below a guaranteed minimum amount, on each policy anniversary depending on the investment experience of the separate account of the prior year's net premium.[5] Regulations provide that death benefits having the characteristics of life insurance proceeds payable by death under contracts such as workers compensation and accident and health contracts are excludable under IRC Section 101(a).[6]

68. How are proceeds taxed if a life insurance policy is owned by someone other than the insured?

The proceeds are taxed in the same manner as if the insured owned the policy. When a person retains all the incidents of ownership in an endowment or annuity contract but designates another to receive the maturity proceeds, the proceeds will be taxed to the owner rather than to the payee (Q 504). For possible gift tax consequences when a policy is owned by one individual but insures another, see Q 209.

Interest Option

69. If life insurance death proceeds are left on deposit with the insurance company under an interest-only option, is the interest taxable income to the beneficiary?

Yes. All amounts paid or credited to a beneficiary as interest (excess and guaranteed) must be included in the beneficiary's gross income regardless of whether the insured or the beneficiary elected the option.[7] The interest is taxable in the first year that it can be withdrawn.

1. TEFRA Sec. 266(c).
2. See Rev. Rul. 66-322, 1966-2 CB 123.
3. See GCM 38934 (12-8-82); GCM 39022 (8-12-83).
4. *Evans v. Comm.*, 56 TC 1142 (1971).
5. Rev. Rul. 79-87, 1979-1 CB 73.
6. Treas. Reg. §1.101-1(a)(1).
7. IRC Sec. 101(c); Treas. Reg. §1.101-3(a).

If the beneficiary elects an option under which there is no right to withdraw either principal or interest for a specified number of years, the entire amount of accumulated interest is taxable in the year during which it first becomes withdrawable.[1] But if the beneficiary has a right to withdraw principal, the interest is taxable when credited even though the agreement stipulates that the interest cannot be withdrawn.[2]

The principal amount held by the insurer, representing the value of the proceeds at the insured's death, is income-tax free to the recipient when withdrawn (Q 62).

For tax treatment when proceeds are held for a period under the interest option and subsequently paid under a life income or installment settlement, see Q 70.

Life Income and Installment Options

70. If excludable death proceeds are held by an insurer and are paid under a life income or installment option, how are the payments treated for income tax purposes?

The "amount held by the insurer" (usually the one-sum proceeds payable at the insured's death) is prorated over the payment period. (If the settlement arrangement involves a life income with a guaranteed refund, or a guaranteed number of payments, the value of the guarantee must be subtracted from the one-sum proceeds before making the proration.) These prorated amounts determine the portion of each payment that may be treated as a return of principal. Consequently, the beneficiary may exclude this portion of each payment from gross income.[3] All amounts received in excess of these prorated amounts are treated as interest, and are taxable as ordinary income to any beneficiary other than the surviving spouse of an insured who died before October 23, 1986. Such a surviving spouse is entitled to exclude up to $1,000 of such interest annually in addition to the prorated amount of principal.[4]

Life Income Option

If the installments are payable for the lifetime of the beneficiary, the "amount held by the insurer" is divided by the beneficiary's life expectancy to determine the amount that may be excluded from gross income each year as a return of principal. In the case of amounts paid with respect to deaths occurring after October 22, 1986, the beneficiary's life expectancy must be determined by use of IRS annuity tables V and VI.[5] In the case of amounts paid with respect to deaths occurring before October 23, 1986, the beneficiary's life expectancy is taken from the mortality table that the insurer uses in determining the amount of the installments (not from the IRS annuity tables).[6] If there is a refund or period-certain guarantee, the amount held by the insurer must be reduced by the present value of the guarantee before prorating for the

1. Treas. Reg. §1.101-4 (g), Ex. 1.
2. *Strauss v. Comm.*, 21 TC 104 (1953); see also Rev. Rul. 68-586, 1968-2 CB 195.
3. IRC Sec. 101(d)(1); Treas. Reg. §1.101-4(a)(1)(i).
4. IRC Sec. 101(d)(1)(B), prior to repeal by TRA '86 Sec. 1001(a); Treas. Reg. §1.101-4(a)(1)(ii).
5. IRC Sec. 101(d)(2)(B)(ii); Treas. Reg. §1.101-7.
6. Treas. Reg. §1.101-4(c).

exclusion.[1] The present value of the guarantee is determined by using the insurer's interest rate and the applicable mortality table. The excludable amount, once determined, remains the same even though the beneficiary outlives his or her life expectancy. The balance of the payments is taxable income to any beneficiary other than the surviving spouse of an insured who died before October 23, 1986. The spouse of such an insured may exclude up to $1,000 of interest each year in addition to excluding the prorated amount of principal. If the beneficiary dies before receiving all guaranteed amounts, the secondary beneficiary receives the balance of the guaranteed refund, or guaranteed payments, tax-free.[2] Excess interest allowed by the company in addition to the guaranteed refund would be taxable income to the secondary beneficiary, however.[3]

> *Example*. Insured husband died after October 22, 1986. Insured's widow elects to receive $75,000 of death proceeds under a refund life income option. The company guarantees her payments of $4,000 a year. According to Table V and the interest rate used by the insurer, her life expectancy is twenty-five years and the present value of the refund guarantee is $13,500. The $75,000 must first be reduced by the value of the refund guarantee ($75,000 – $13,500 = $61,500). This reduced amount, $61,500, is then divided by her life expectancy to find the amount that she may exclude from gross income each year as return of principal. This amount is $2,460 ($61,500 ÷ 25). Her taxable income from the guaranteed payment is $1,540 a year ($4,000 – $2,460). If the widow dies before receiving the full $75,000, the balance of the guaranteed amount will be received tax-free by the secondary beneficiary.

If a joint-and-survivor option is elected, the "amount held by the insurer" is divided by the life expectancy of the beneficiaries as a group to determine the annual exclusion of principal (see above for the appropriate mortality table to be used). The same amount of principal is excludable during the joint lives and the lifetime of the survivor.[4]

Fixed Period Option

The "amount held by the insurer" is divided by the number of installment payments to be made in the fixed period. The quotient is the portion of each payment that is excludable from the beneficiary's gross income as a return of principal. The balance of each guaranteed payment generally must be included in the beneficiary's gross income. In addition to the prorated amount of principal, the surviving spouse of an insured who died before October 23, 1986, may exclude up to $1,000 of interest each year (guaranteed and excess).[5] If the primary beneficiary dies before the end of the fixed period, the secondary beneficiary may exclude the same amount of prorated principal from gross income, but all interest (guaranteed and excess) is includable.[6]

> *Example*. Insured husband died after October 22, 1986. Insured's widow elects to receive $50,000 of proceeds in ten annual installments of $5,500 each. As a second payment, she receives $5,950 (guaranteed payment plus $450 excess interest). She may exclude $5,000 of the payment as a return of principal ($50,000 ÷ 10). Consequently, she must include in income the balance of the payment ($950).

1. Treas. Reg. §1.101-4(e).
2. Treas. Reg. §1.101-4(d)(3).
3. Treas. Reg. §1.101-4(d)(3) and (g), Ex. 7.
4. Treas. Reg. §1.101-4(d)(2) and (g), Ex. 5.
5. Treas. Reg. §1.101-4(a)(2), Ex. 1 and 2.
6. Treas. Reg. §1.101-4(a)(2), Ex. 3.

Fixed Amount Option

The "amount held by the insurer" is divided by the number of payments required to exhaust principal and guaranteed interest. The quotient is the portion of each payment that is excludable from the beneficiary's gross income as a return of principal. The balance of each guaranteed payment generally must be included in the beneficiary's gross income.[1] The surviving spouse of an insured who died before October 23, 1986, may exclude up to $1,000 of interest each year in addition to the prorated amount of principal. Payments extending beyond the guaranteed period (payments comprised entirely of excess interest) are fully taxable. (There is a difference of opinion as to whether the surviving spouse's $1,000 annual interest exclusion, even if otherwise available, can be applied to these additional excess interest payments.) If the primary beneficiary dies before the end of the guaranteed payment period, the secondary beneficiary may exclude the same amount of prorated principal from gross income.

Surviving Spouse's $1,000 Annual Exclusion

In addition to the prorated exclusion of principal (see above), the surviving spouse of an insured *who died prior to October 23, 1986*, is entitled to exclude from gross income up to $1,000 of interest (guaranteed and excess) in each taxable year. (The surviving spouse's $1,000 annual exclusion was repealed for surviving spouses of insureds who die after October 22, 1986.) No more than $1,000 of interest may be excluded annually with respect to one insured, regardless of the number of policies. But if the beneficiary is the surviving spouse of more than one insured, he or she is entitled to a $1,000 annual interest exclusion with respect to policies on the life of each insured.[2] To qualify for this additional exclusion, the surviving spouse must have been married to the insured when the insured died. An absolute divorce disqualifies the beneficiary, although a legal separation or an interlocutory decree does not.[3] The surviving spouse's remarriage does not affect his or her qualification.[4] This $1,000 annual exclusion is available only with respect to the interest element in life income or installment payments; it is not available with respect to interest payments under an interest-only option. In other words, the settlement must provide for a substantial diminution of principal during the period the interest is received.[5] It would appear that because payments of proceeds (including interest) from National Service Life Insurance (NSLI) otherwise are exempted from taxation, the receipt of NSLI proceeds under an installment settlement will not reduce the $1,000 annual exclusion (Q 134).

71. What are the tax consequences of changing the method of receiving the proceeds of a life insurance policy?

The surviving spouse of an insured who died before October 23, 1986, is not precluded from obtaining the benefits of the $1,000 annual interest exclusion at a later date simply because the surviving spouse originally elected to leave the proceeds with the insurer under the interest-only option. A new election to take the proceeds under a life income or other

1. Treas. Reg. §1.101-4(g), Ex. 2.
2. IRC Sec. 101(d)(1)(B), prior to repeal by TRA '86 Sec. 1001(a); Treas. Reg. §1.101-4(a)(2), Ex. 2.
3. Treas. Reg. §1.101-4(a)(1)(ii); see *Eccles v. Comm.*, 19 TC 1049 (1953), *aff'd* 208 F.2d 796 (4th Cir. 1953).
4. Rev. Rul. 72-164, 1972-1 CB 28.
5. Treas. Reg. §1.101-3(a).

installment option will entitle the surviving spouse to the annual interest exclusion.[1] During the time the proceeds are held under the interest-only option, the interest will be fully taxable to him or her as received (Q 69). Payments under the life income or installment option will be treated as explained in Q 70.

Insured Died Before August 17, 1954

In tax years beginning before January 1, 1977, the full installment or life income payment was tax-free to the beneficiary except excess interest, provided the option was elected under a contract right.[2] Effective for tax years beginning on or after January 1, 1977, IRC Section 101(f) was repealed.[3] As a result, these payments fall within the general rules (above) applicable where the insured died after August 16, 1954.

Transferred Policy

72. Are death proceeds wholly tax-exempt if an existing life insurance policy is sold or otherwise transferred for valuable consideration?

As a general rule, death proceeds are wholly exempt from income tax (Q 62, Q 64). An exception to this rule, however, is that the proceeds are not wholly exempt if the policy, or any interest in the policy, has been transferred, by assignment or otherwise, for valuable consideration.[4] This exception is known as the "transfer for value rule." Under this rule, the proceeds will be subject to income tax to the extent that they exceed the consideration paid (and premiums subsequently paid) by the person to whom the policy is transferred. Also, for contracts issued after June 8, 1997 (in taxable years ending after this date), any interest paid or accrued by the transferee on indebtedness with respect to the policy is added to the amount exempt from tax after the transfer if the interest is not deductible under IRC Section 264(a)(4).[5]

This unfavorable result is avoided if the transfer for value is "to the insured, to a partner of the insured, or to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, or if the basis of the policy in the hands of the transferee must be determined (at least in part) by reference to the transferor's basis (e.g., carryover basis)."[6] (For application of the transfer for value rule to business insurance, see Q 264 to Q 275).

Planning Point: If a transfer is contemplated and no exception is available, it is generally accepted that creation of a partnership between the insured and the transferee at or near the time of transfer can avoid the application of the transfer for value rule. This newly created partnership, however, should have a valid purpose (other than tax avoidance) so as to not be disregarded by the IRS. Please note that the exceptions above do NOT include a transfer to a fellow shareholder of a corporation in which the insured is a shareholder. It is often (wrongly) assumed that a transfer to a fellow shareholder or officer is an exception since the transfer to a fellow partner is an exception.

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1. Rev. Rul. 65-284, 1965-2 CB 28.
2. IRC Sec. 101(f) as in effect prior to January 1, 1977.
3. TRA '76 Sec. 1901(a)(16).
4. IRC Sec. 101(a)(2).
5. IRC Sec. 101(a)(2).
6. IRC Sec. 101(a)(2).

The unfavorable result, however, is not avoided merely because the person to whom the policy is transferred has an insurable interest in the insured. For example, often an insured will transfer his or her policy to a son or daughter. If the transfer is a gift, the named beneficiary will receive the proceeds wholly free of income tax. But if the insured receives valuable consideration for the transfer, the proceeds will be taxable income to the beneficiary (to the extent they exceed the consideration, premiums, and other amounts subsequently paid).[1] The fact that no money was exchanged for the policy does not necessarily mean that the transfer was a gift and therefore was not subject to the transfer for value rule. For example, when two insured individuals assign policies on their own lives to each other at about the same time, it could be argued that neither transfer was a gift. The transfer of a policy subject to a nonrecourse loan may be a transfer for value (Q 265). However, when a policy is owned by someone other than the insured, a transfer for value to the insured will not cause loss of tax exemption for the proceeds. Moreover, in the case of successive transfers, the proceeds will be wholly tax-exempt if the final transfer, or the last transfer for value, is to the insured or to his or her partner, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.[2] See Q 74 for a transfer to a spouse (or former spouse, if incident to a divorce).

73. Are death proceeds of life insurance wholly tax-exempt if the policy has been transferred as a gift?

Generally, the donee steps into the shoes of the donor. Thus, the entire proceeds are exempt if they would have been exempt had the policy been retained by the donor. If the donor purchases the policy from another owner and no exceptions to the transfer-for-value rule (Q 72) apply, however, then only the consideration paid by the donor, plus net premiums (and certain other amounts) subsequently paid by the donor and donee, is exempt.

As an exception to this general rule, however, the proceeds will be wholly tax-exempt – despite any previous transfer for value – if the final transfer is made *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 an officer or shareholder.[3] The IRS has ruled that when a life insurance policy subject to a policy loan is transferred, there is a transfer for value; if the transfer is partly a gift, it may come within one of the exceptions to the transfer for value rule (Q 264, #3).[4]

74. Will the transfer of a life insurance policy between spouses result in loss of the tax exemption for the death proceeds?

The transfer of a life insurance policy between spouses (or former spouses if incident to a divorce, Q 101) generally will not result in the loss of exemption for the death proceeds if the transfer occurs after July 18, 1984 (unless the transfer is pursuant to an instrument in effect on or before such date), or after December 31, 1983, and both spouses (or former spouses if incident to a divorce) elect to have the nonrecognition rules of IRC Section 1041 apply.

1. Treas. Reg. §1.101-1(b); *Bean v. Comm.* TC Memo 1955-195.
2. IRC Sec. 101(a)(2)(B); Treas. Reg. §1.101-1(b).
3. Treas. Reg. §1.101-1(b); *Hacker v. Comm.*, 36 BTA 659 (1937).
4. Rev. Rul. 69-187, 1969-1 CB 45; Let. Rul. 8951056.

The transferee is treated as having acquired the policy by gift and the transferor's basis is carried over to the transferee.[1] IRC Section 101(a)(2)(A) provides that the transfer for value rule does not apply if the basis of the contract for determining gain or loss in the hands of the transferee is determined by reference to the basis of the contract in the hands of the transferor. If a life insurance policy with a loan is transferred in trust and gain is recognized by the transferor (Q 101), the basis in the transferee's hands is adjusted to reflect the gain, but the transfer may nonetheless come within an exception to the transfer for value rule (Q 264 #3).

If the transfer occurs either prior to July 19, 1984, or after July 18, 1984, but pursuant to an instrument in effect before such date *and* no election to have the nonrecognition rules of IRC Section 1041 apply has been made, then the nature of the transfer determines whether the transfer for value rule applies. If the transfer was made pursuant to a property settlement agreement incident to a divorce, then the policy may be considered to have been transferred for value (e.g., in exchange for the release of marital rights). If the transfer between spouses was in the nature of a gift, then no loss of the exemption would result.

Estate Tax Issues

75. What benefits payable at death are included in the term "life insurance" for estate tax purposes?

IRC Section 2042 deals with the estate taxation of proceeds from insurance on the life of a decedent. According to regulations, the term "insurance," as used in IRC Section 2042, means life insurance of every description, including death benefits paid by fraternal societies operating under the lodge system.[2] In the case of a retirement income endowment, the death proceeds are treated as insurance proceeds under IRC Section 2042 if the insured dies before the terminal reserve value equals or exceeds the face value. If the insured dies after that time, the proceeds are treated as death proceeds of an annuity contract (Q 542, Q 544).[3]

With respect to the proceeds of "no-fault" automobile liability insurance, the IRS has ruled on three categories of benefits:

(1) *Survivors' loss benefits*. These are benefits payable only to certain named dependent survivors of the insured. If the insured dies leaving no such eligible dependents, no benefits are paid. The value of any such benefit is not includable in the insured's gross estate under IRC Section 2033 or under IRC Section 2042(2) because if the proceeds are life insurance (an issue the ruling did not decide) the insured would not have owned any incidents of ownership (Q 81) at his or her death.[4]

(2) *Basic economic loss benefit*. This benefit covers the insured's medical expenses and loss of income arising from the insured's injury while operating an automobile. The value of this benefit is includable in the insured's gross estate under

1. IRC Sec. 1041.
2. Treas. Reg. §20.2042-1(a).
3. Treas. Reg. §20.2039-1(d).
4. Rev. Rul. 82-5, 1982-1 CB 131.

IRC Section 2033, but not under IRC Section 2042(1) (life insurance proceeds payable to or for the insured's estate).[1]

(3) *Death benefit*. This is a benefit payable unconditionally to the estate of the insured and to the estate of any passenger in the insured's car killed in a covered accident. The value of this benefit is includable under IRC Section 2042(1) in the estate of each insured receiving the benefit.[2]

76. When are death proceeds of life insurance includable in an insured's gross estate?

They are includable in the following four situations:

(1) The proceeds are payable to the insured's estate, or are receivable for the benefit of the insured's estate (Q 77 to Q 79).[3]

(2) The proceeds are payable to a beneficiary other than the insured's estate but the insured possessed one or more incidents of ownership in the policy at the time of the insured's death, whether exercisable by the insured alone or only in conjunction with another person (Q 80 to Q 87);[4]

(3) The insured has made a gift of the policy on the insured's life within three years before his or her death (Q 91);[5]

(4) The insured has transferred the policy for less than an adequate consideration (i.e., the transaction was not a bona fide sale) and the transfer falls within one of the rules for includability contained in IRC Sections 2035, 2036, 2037, 2038, or 2041. Under these circumstances, the value of the proceeds in excess of the value of the consideration received is includable in an insured's estate.[6] A grantor may retain the power to substitute property of an equivalent value. Such a power, in and of itself, generally does not cause the trust corpus to be includable under IRC Section 2036 or 2038.[7]

77. If life insurance proceeds are payable to an insured's estate, is the value of the proceeds includable in the insured's estate?

Yes. The entire value of the proceeds must be included in the insured's gross estate even if the insured possessed no incident of ownership in the policy, and paid none of the premiums.[8] But see Q 162 and Q 163 for the rule in community property states. Proceeds payable to an

1. Rev. Rul. 83-44, 1983-1 CB 228.
2. Rev. Rul. 83-44, above.
3. IRC Sec. 2042(1).
4. IRC Sec. 2042(2).
5. IRC Sec. 2035.
6. IRC Sec. 2043.
7. Rev. Rul. 2008-22, 2008-16 IRB 797.
8. IRC Sec. 2042(1); *Est. of Bromley v. Comm.*, 16 BTA 1322 (1929).

executor in the executor's individual capacity rather than as executor for the insured's estate were not treated as payable to the insured's estate by the Tax Court.[1]

78. When are life insurance proceeds includable in an insured's gross estate even though the insured has no incident of ownership in the policy and the proceeds are not payable to the insured's estate?

Proceeds are includable in an insured's gross estate if they are receivable by or *for the benefit of* the insured's estate. Thus, if the beneficiary is under a legally binding obligation to pay debts or taxes of the insured's estate, the amount of proceeds required to discharge these debts and taxes (to the extent of the beneficiary's obligation) is includable in the insured's gross estate. This is so even though the insured possessed no incidents of ownership in the policy at the insured's death.[2] State law generally requires a life insurance beneficiary to forfeit the proceeds if the beneficiary is convicted of feloniously killing the insured. Where state law further provides that in such case proceeds will be distributed to beneficiaries of the insured's estate (other than to the felon), it has been held that the proceeds are treated for federal estate tax purposes as payable to the insured's estate.[3] (With respect to insurance assigned as collateral, see Q 132; for discretionary powers that may be granted to a trustee, see Q 177.)

79. Are the proceeds from life insurance taken out to pay an insured's death taxes includable in the insured's estate?

Yes.

The proceeds are includable in the insured's gross estate if the beneficiary has a legally binding obligation to use them to pay the insured's death taxes.[4] For powers that may be given to a trustee, see Q 177.

Planning Point: Proceeds should not be includable in the gross estate merely because the beneficiary lends the proceeds to the estate, or uses the proceeds to buy assets from the estate. Liquidity can be provided to an estate in this manner.

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80. When are life insurance proceeds payable to a beneficiary other than the insured's estate includable in the insured's estate?

Proceeds are includable in an insured's gross estate if the insured *legally possessed* and could *legally exercise* any incidents of ownership at the time of the insured's death. It does not matter that the insured did not have possession of the policy and therefore was unable to exercise ownership rights at the time of death,[5] or that the insured was unable as a practical matter to effect any change in the policy because the policy was collaterally assigned.[6]

1. *Est. of Friedberg v. Comm.*, TC Memo 1992-310.
2. Treas. Reg. §20.2042-1(b)(1); *Hooper v. Comm.*, 41 BTA 114 (1940), nonacq. 1940-1 CB 3 (1940); *Est. of Rohnert v. Comm.*, 40 BTA 1319 (1939); *Pacific Nat'l Bank of Seattle (Morgan) v. Comm.*, 40 BTA 128 (1939); *Davidson's Est. (Fourth Nat'l Bank in Wichita) v. Comm.*, 158 F.2d 239 (10th Cir. 1946).
3. *Est. of Draper v. Comm.*, 536 F.2d 944 (1st Cir. 1976); *First Kentucky Trust Co. v. U.S.*, 84-2 USTC ¶13,581 (6th Cir. 1984); Let. Rul. 7909056.
4. Treas. Reg. §20.2042-1(b)(1).
5. *Comm. v. Est. of Noel*, 380 U.S. 678 (1965).
6. *Est. of Goodwyn v. Comm.*, TC Memo 1973-153.

The proceeds are includable even if the insured cannot exercise his or her ownership rights alone, but only in conjunction with another person.[1] It has been held that an insured did not possess incidents of ownership where the insured had paid no premiums, did not regard the policy as the insured's own, and had made an irrevocable designation of beneficiary and mode of payment of proceeds.[2] (For what constitutes an incident of ownership, see Q 81.) But even if the proceeds are payable to a beneficiary other than the insured's estate, and the insured possesses no incidents of ownership in the policy, the proceeds are nevertheless includable in the insured's gross estate if they are receivable for the benefit of the insured's estate (Q 78). Even though the insured retains no incidents of ownership in the policy, the proceeds may be includable in the insured's estate if the insured has transferred the policy within three years before the insured's death (Q 91; see also Q 174).

81. What are the incidents of ownership that will cause life insurance proceeds to be includable in the insured's estate?

Proceeds are includable in an insured's gross estate if the insured possesses any incidents of ownership at death including, but not limited to, the following:

- the right to change the beneficiary;
- the right to surrender or cancel the policy;
- the right to assign the policy;
- the right to revoke an assignment;
- the right to pledge the policy for a loan; or
- the right to obtain a policy loan.[3]

The reservation of a right to make premium loans has been held to be an incident of ownership.[4] A right to change contingent beneficiaries, who are to receive benefits after the primary beneficiary's death, also is an incident of ownership.[5]

The mere right to change the time or manner of payment of proceeds to the beneficiary, as by electing, changing, or revoking settlement options, has been held an incident of ownership,[6] but the Tax Court and the U.S. Court of Appeals for the Third Circuit have held to the contrary.[7] (In 1981, the IRS reiterated its opposition to the Third Circuit's holding in *Connelly*,

1. IRC Sec. 2042(2); *Goldstein's Est. v. U.S.*, 122 F. Supp. 677 (Ct. Cl. 1954).
2. *Morton v. U.S.*, 457 F2d 750, 29 AFTR 2d 72-1531 (4th Cir. 1972).
3. Treas. Reg. §20.2042-1(c)(2); *Chase Nat'l Bank v. U.S.*, 278 U.S. 327 (1929); *Est. of DeVos v. Comm.*, TC Memo 1975-216; *Est. of Riefberg v. Comm.*, TC Memo 1982-70; *Allentown Nat'l Bank v. Comm.*, 37 BTA 750 (1938).
4. *Est. of McCoy v. Comm.*, TC Memo 1961-40.
5. *Broderick v. Keefe*, 112 F.2d 293 (1st Cir. 1940); *Est. of Newbold v. Comm.*, 4 TCM (CCH) 568 (1945).
6. *Est. of Lumpkin v. Comm.*, 474 F.2d 1092 (5th Cir. 1973).
7. *Lumpkin v. Comm.*, 56 TC 815 (1971), rev'd by 5th Cir. (above); *Billings v. Comm.*, 35 BTA 1147 (1937), acq. withdrawn 1972-1 CB 3; *Est. of Connelly v. U.S.*, 551 F.2d 545 (3rd Cir. 1977).

and indicated its intent to continue to oppose that result in all circuits except the Third (Pa., Del., N.J., Virgin Islands).[1]

According to a Technical Advice Memorandum, trust provisions that changed the beneficial interest from a decedent's spouse to the decedent's children if the decedent and the decedent's spouse became divorced were not the equivalent to a retained incident of ownership that would bring the life insurance proceeds into the decedent's estate.[2] The memorandum implies that the result would have been different if the trust had provided that the beneficial interest would revert to the decedent upon divorce.

The right to receive disability income is an incident of ownership if payment of disability benefits would reduce the face amount payable at death.[3] But where an employer corporation owned the policy and the insured employee was entitled to benefits under a disability income rider, the IRS did not claim that the right to the disability income was an incident of ownership that would cause the proceeds to be includable in insured's gross estate.[4]

A more than 5 percent reversionary interest in the proceeds is an incident of ownership (Q 84).[5] When a wife, who owned insurance on her husband's life and who was the primary beneficiary, changed the contingent beneficiary from her estate to whomever the insured named in his will, the IRS ruled that the insured did not possess at his death an incident of ownership (Q 85).[6]

82. What are the incidents of ownership of employer-paid death benefits that would cause life insurance proceeds to be includable in the insured's estate?

An employee insured's right to designate the beneficiary of an employer-paid death benefit is not treated as an incident of ownership in the insurance funding the benefit if the employer is sole owner of the policy and sole beneficiary for its exclusive use.[7] The IRS has taken the position that if the insured under a corporation-owned policy has an agreement with the corporation giving the insured the first right to purchase the policy for its cash surrender value if the corporation decides to discontinue the coverage, the purchase option is an incident of ownership.[8] The Tax Court has held, however, that the insured's contingent purchase option as described in Revenue Ruling 79-46 is not an incident of ownership within the meaning of IRC Section 2042(2).[9]

The IRS also has ruled that where, under an insured stock redemption agreement, a stockholder had the right to purchase the policies the corporation owned on the insured's life if the

1. Rev. Rul. 81-128, 1981-1 CB 469.
2. TAM 8819001.
3. *Old Point Nat'l Bank v. Comm.*, 39 BTA 343 (1939).
4. *Est. of Morrow v. Comm.*, 19 TC 1068 (1953), acq. 1954-1 CB 5, nonacq. 1979-2 CB 2; *Est. of Dorson v. Comm.*, 4 TC 463 (1944).
5. IRC Sec. 2042(2).
6. Rev. Rul. 79-117, 1979-1 CB 305.
7. *Est. of Morrow*, above in Q 81.
8. Rev. Rul. 79-46, 1979-1 CB 303.
9. *Est. of Smith v. Comm.*, 73 TC 307 (1979), acq. in result, 1981-1 CB 2.

insured ceased being a stockholder, such contingent purchase option was not an incident of ownership in the insurance.[1] An insured who held the right to purchase a policy upon termination of a buy-sell agreement did not possess incidents of ownership so long as the contingency had not occurred, but would possess incidents once the agreement was terminated.[2]

Also, a shareholder was not treated as holding incidents of ownership in a life insurance policy where the shareholder could purchase a corporate-owned policy upon disability, or upon a cross-purchase of the shareholder's stock if the shareholder dissented to sale of the corporation to a third party or a public offering.[3] However, an insured was treated as holding incidents of ownership in a policy held in a trusteed buy-sell arrangement where the insured was considered to have transferred the policy to the trust and retained the right to purchase the policy for its cash surrender value.[4]

The right to receive dividends has been held *not* to be an incident of ownership in the policy.[5] It has been held that if the insured has the power to terminate the interest of the primary beneficiary with only the consent of the secondary beneficiary, the insured has an incident of ownership.[6] However, a sole shareholder would not be treated as holding incidents of ownership in a life insurance policy on the shareholder's own life where a collateral consequence of a termination of an employee's employment would be a termination of the employee's option agreement to purchase the shareholder's stock with a corresponding change in beneficiary of the insurance proceeds held in an irrevocable life insurance trust created by the employee.[7]

The assignment of a life insurance policy by a third-party owner as an accommodation to the insured to cover the insured's debts does not in itself create in the insured an incident of ownership.[8] But if a policy owner collaterally assigns a policy as security for a loan and then makes a gift of the policy subject to the assignment, the donor will be deemed to have retained an incident of ownership.[9]

Where an insurance funded buy-sell agreement prohibited each partner from borrowing against, surrendering, or changing the beneficiary on the policy each owned on the life of the other partner without the insured's consent, the Tax Court held that the decedent-insured did not possess an incident of ownership in the policy insuring the decedent-insured's life.[10] However, it has been reported that the IRS, citing an internal ruling dated January 7, 1971, has declined to follow the decision.[11]

1. Let. Rul. 8049002.
2. TAM 9127007.
3. Let. Rul. 9233006.
4. TAM 9349002.
5. *Est. of Bowers v. Comm.*, 23 TC 911 (1955), acq.; *Old Point Nat'l Bank*, supra.
6. *Est. of Goodwyn v. Comm.*, TC Memo 1973-153.
7. TAM 9421037.
8. *Est. of Goodwyn*, supra.
9. *Est. of Krischer v. Comm.*, TC Memo 1973-172.
10. *Est. of Infante v. Comm.*, TC Memo 1970-206 (appeal dismissed), nonacq. 1971 AOD LEXIS 310 (1971).
11. 55 *Taxes* (CCH) 146 (Feb. 1977).

An insured was treated as holding incidents of ownership in a policy held in a trusteed buy-sell arrangement where the trust could only act as directed by the shareholders through the buy-sell agreement and the insured could thus withhold consent to the exercise of policy rights.[1]

Where an insured absolutely assigned a policy that required the insured's consent before the policy could be assigned, or the beneficiary changed, to someone who had no insurable interest in the insured's life, the IRS ruled that the insured had retained an incident of ownership.[2]

Similarly, the Tax Court has held that an employee's right to consent to a change of beneficiary on a split dollar policy owned by the employee's employer on the employee's life is an incident of ownership.[3] The Tax Court also has held that where the insured assigned policies, retaining the right to consent to the assignee's designating as beneficiary, or assigning the policies to, anyone who did not have an insurable interest in the insured's life, the assignee's act of designating an irrevocable beneficiary did not eliminate the insured's retained incidents of ownership. The Third Circuit reversed the Tax Court in this case, however, taking the position that because under the facts presented the insured could not have enjoyed any economic benefit from exercising the insured's veto power over the designation of beneficiaries or assignees, the insured's retained power did not amount to an incident of ownership.[4] The insured's right to purchase the policy from an assignee was treated as equivalent to the right to revoke an assignment, which is an incident of ownership.[5]

83. If an insured holds incidents of ownership at death as a fiduciary or by reason of a retained right to remove a trustee and appoint another, will the life insurance proceeds be includable in the insured's estate?

Revenue Ruling 84-179[6] provides that incidents of ownership held by the insured in a fiduciary capacity will cause the proceeds to be included in the insured's estate only if (1) the incidents are exercisable for the insured's personal benefit, *or* (2) the insured transferred the policy or at least some of the consideration for purchasing or maintaining the policy to the trust from personal assets *and* the incidents of ownership devolved upon the insured as part of a prearranged plan involving the participation of the insured. The IRS states that this position is consistent with *Skifter*, *Fruehauf*, and *Hunter*, courts of appeals decisions discussed below.

The regulations say that a decedent is considered to have an "incident of ownership" in an insurance policy on the decedent's 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

1. TAM 9349002 (cf. Let. Ruls. 9511009 and 9622036, in which no estate inclusion was required for life insurance held in a trust to fund a corporate buy-sell agreement).
2. Rev. Rul. 75-70, 1975-1 CB 301.
3. *Schwager v. Comm.*, 64 TC 781 (1975).
4. *Est. of Rockwell v. Comm.*, 57 AFTR 2d 86-1491, 779 F2d 931 (3rd Cir. 1985), rev'g TC Memo 1984-654.
5. TAM 9128008.
6. 1984-2 CB 195, revoking Rev. Rul. 76-261, 1976-2 CB 276.

time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.[1] The IRS says it will read this regulation in accordance with its position adopted in Rev. Rul. 84-179, above. The courts have taken three different views of the regulation:

First, the U.S. Court of Appeals for the Sixth Circuit has held that the possession by the insured of incidents of ownership in a fiduciary capacity is not enough to bring the proceeds into the insured's estate under IRC Section 2042(2) unless the insured had the power at death to benefit the insured or the insured's estate by exercising any of the incidents.[2] This also appears to be the view of the Tax Court.[3] See, also, *Est. of Jordahl v. Comm.*,[4] where the Tax Court held that the decedent's right, as trustee of a funded life insurance trust of which the decedent was grantor and in which the decedent had an income interest, to borrow against the policies to keep them in effect if trust income was insufficient, was not an incident of ownership because in fact the income never was insufficient. The court, in *Jordahl*, also ruled that the decedent's reservation of the right, as grantor, to substitute "other policies of equal value" for those held in trust at any time was not an incident of ownership.

Second, the U.S. Court of Appeals for the Second Circuit has limited the application of the foregoing regulation as follows: If an insured at death possesses incidents of ownership in the insurance only as a consequence of having received them by transfer from a third-party policy owner long after the insured had been divested of all interest in the insurance (if the insured ever had any interest), then the proceeds are not includable in the insured's estate under Section 2042(2) unless the insured possessed the power to benefit the insured or the insured's estate by exercising any of the incidents the insured possessed. If an insured is also the policy owner and is the transferor of the insurance to a trust, then any incidents of ownership the insured possesses at death, as trustee or otherwise, will cause includability of the proceeds in the insured's estate, even if the insured cannot benefit economically by exercising those incidents.[5]

Third, the U.S. Court of Appeals for the Fifth Circuit takes the view that the insured's mere possession at death of an incident of ownership (even the limited right, as trustee, to alter the time or manner of payment of death proceeds to the beneficiary), regardless of whether the insured or the insured's estate could have benefited by exercising the incident and regardless of how the insured came into possession of such incident, is sufficient to cause the proceeds to be included in the insured's estate under IRC Section 2042(2).[6]

The Fifth Circuit seems to stand alone in its broad view of IRC Section 2042(2). Courts outside the Fifth Circuit (in addition to the Tax Court and Second and Sixth Circuits) generally have taken the view that an insured who receives fiduciary powers over policies of insurance on the insured's life from a third-party policy owner does not (merely by reason of possessing those powers) possess incidents of ownership in such policies unless it is possible for the insured

1. Treas. Reg. §20.2042-1(c)(4).
2. *Est. of Fruehauf v. Comm.*, 427 F.2d 80 (6th Cir. 1970).
3. *Est. of Skifter v. Comm.*, 56 TC 1190 (1971), rev'd 468 F.2d 699, nonacq. 1978-1 CB 3 (see text below).
4. 65 TC 92 (1975), acq. 1977-1 CB 1.
5. *Est. of Skifter v. Comm.*, 468 F.2d 699 (2nd Cir. 1972).
6. *Rose v. U.S.*, 511 F.2d 259 (5th Cir. 1975); *Terriberry v. U.S.*, 517 F.2d 286 (5th Cir. 1975), cert. denied 424 U.S. 977. In Rev. Rul. 84-179, above, IRS revoked Rev. Rul. 76-261, which supported the Fifth Circuit's position.

or the insured's estate to benefit economically by exercising any of those powers.[1] Where the decedent-insured as executor was given the power to surrender policies for cash to pay death taxes and settlement costs, because such costs were paid with nonprobate assets, it was held that the decedent did not possess incidents of ownership but only a power over a contingency that never arose.[2] It has been held, however, that if the insured has the power to benefit by exercising a fiduciary power, it does not matter that the insured can exercise the power only with the consent of co-trustees whose interests in the trust are adverse to the insured's own interests.[3] If an insurance trust gives the trustee-insured the power to deal with the insurance policies held by the trust as if the trustee-insured were the absolute owner and without the necessity to account to anyone for the trustee-insured's dealings, the trustee-insured still has fiduciary powers that must be exercised only for the exclusive benefit of the trust beneficiaries. If the trustee-insured violates his or her fiduciary duty by, say, pledging the policies to secure a personal loan, the trustee-insured's wrongful act does not convert these powers into incidents of ownership for purposes of IRC Section 2042.[4]

84. If an insured possesses incidents of ownership at death as a fiduciary or by reason of a retained right to remove a trustee and appoint another, are there any situations in which the life insurance proceeds will not be includable in the insured's estate?

A technical advice memorandum advised that if a trustee possessed incidents of ownership in a life insurance policy held for the trust and the insured/grantor retained the right to remove trustees and appoint anyone other than the insured/grantor as trustee, the insured/grantor retained incidents of ownership in the policy that would cause the insurance proceeds to be included in the insured/grantor's estate under IRC Section 2042(2).[5] However, for purposes of IRC Sections 2036 or 2038, the IRS will no longer include trust property in a decedent grantor's estate when the grantor retains the right to replace the trustee but can replace the trustee only with an independent corporate trustee.[6] (One wonders whether the IRS will extend its policy with regard to trustee removal under IRC Sections 2036 and 2038 to IRC Section 2042.) A later letter ruling determined that the right to replace a trustee *for cause* with someone other than the insured/grantor was not an incident of ownership.[7]

The issue of incidents of ownership in a trust generally can be avoided by providing that an insured cannot exercise any incident of ownership in a policy on the insured's life (even as a trustee).[8] Letter Ruling 9748020 concluded that where a spouse resigned as trustee of a credit shelter bypass trust (in which the decedent had given the spouse an income interest) prior to

1. *Gesner v. U.S.*, 220 Ct. Cl. 433, 600 F2d 1349 (Ct. Cl. 1979); *Hunter v. U.S.*, 624 F.2d 833 (8th Cir. 1980). See also *Est. of Connelly v. U.S.*, 551 F.2d 545 (3rd Cir. 1977).
2. *Hunter*, above.
3. *Gesner*, above.
4. *Est. of Bloch v. Comm.*, 78 TC 850 (1982).
5. TAM 8922003.
6. Rev. Rul. 95-58, 1995-2 CB 191; Est. of *Wall v. Comm.*, 101 TC 300 (1993).
7. Let. Rul. 9832039.
8. See Let. Rul. 9348028.

purchase of life insurance by the trust on the spouse's life, proceeds of the life insurance would not be includable in the other spouse's estate provided that:

(1) the spouse has not transferred any assets to the trust;

(2) the premiums for the policy are paid from the trust corpus;

(3) the spouse does not maintain the policy with personal assets;

(4) the spouse is not reinstated as trustee.

85. Are life insurance proceeds includable in the insured's estate if someone other than the insured took out the policy and owns it at the insured's death?

Proceeds ordinarily are not includable in the insured's gross estate if the insured has never owned the policy and the proceeds are not payable to or for the benefit of his estate.[1] (But see Q 78.) If the terms of the policy give the insured any legal incidents of ownership, however, the proceeds may be included in the insured's gross estate even though a third party purchased the policy and always has retained physical possession of it.[2]

Even though a policy says clearly that incidents of ownership belong to the insured, if it also is clear from facts outside the policy that it was the intention and belief of the parties involved in purchasing the insurance that these ownership rights were to be, and were, placed in another, courts may allow the "intent facts" to override the "policy facts." That is, they may find that the insured did not actually possess the incidents of ownership the policy said were exercisable by the insured.[3]

On the other hand, even though the policy does not give the insured any incidents of ownership, an incident of ownership may be given to the insured by an outside document, such as a corporate resolution, a trust indenture, or another agreement between the insured and the third party.[4] The fact that the insured has had no opportunity to exercise the legal incidents of ownership is immaterial.[5] Also, if the insured causes insurance to be bought on the insured's life by another with funds supplied by the insured and then dies within three years of the purchase, the proceeds may be includable in the insured's estate (Q 91). In *Est. of Margrave v. Comm.*,[6] the U.S. Court of Appeals for the Eighth Circuit affirmed a 9-7 decision of the Tax Court holding that the proceeds of a wife-owned policy, payable revocably to the trustee of a revocable trust created by the insured husband, were not includable in the insured's estate

1. IRC Sec. 2042.
2. *U.S. v. Rhode Island Hosp. Trust Co.*, 355 F.2d 7 (1st Cir. 1966).
3. *National Metropolitan Bank v. U.S.*, 87 F. Supp. 773 (Ct. Cl. 1950); *Schongalla v. Hickey*, 149 F.2d 687 (2d Cir. 1945), cert. denied 326 U.S. 736; *Watson v. Comm.*, TC Memo 1977-268; *First Nat'l Bank of Birmingham v. U.S.*, 358 F.2d 625 (5th Cir. 1966); Let. Rul. 8610068.
4. *Est. of Thompson v. Comm.*, TC Memo 1981-200; *St. Louis Union Trust Co. (Orthwein) v. U.S.*, 262 F. Supp. 27 (E.D. Mo. 1966); *Est. of Tomerlin v. Comm.*, TC Memo 1986-147.
5. *Comm. v. Est. of Noel*, 380 U.S. 678 (1965).
6. 71 TC 13 (1978), aff'd 45 AFTR 2d ¶148,393 (8th Cir. 1980).

under either IRC Section 2042 (incidents of ownership test – see Q 81) or IRC Section 2041 (general power of appointment). The IRS has agreed to follow the holding in *Margrave*.[1]

86. Can an insured remove existing life insurance from the insured's gross estate by an absolute assignment of the policy?

Yes, assuming the insured lives for at least three years after the assignment (Q 91), the insured assigns *all* incidents of ownership, and the assignee is not legally obligated to use the proceeds for the benefit of the insured's estate.[2]

If the form of the assignment reserves any incidents of ownership to the insured, the proceeds may be included in the insured's gross estate despite the insured's clear intention to transfer all ownership rights.[3] It has been held that where the insured had paid no premiums and had never treated the policy as the insured's own, the insured's irrevocable designation of beneficiaries and mode of payment of proceeds was an effective assignment of all of the insured's incidents of ownership in the policy.[4] The amount of any *premiums* paid on the assigned policy by the insured may be included to the extent they are paid within three years of death (Q 91). (For indirect possession of incidents of ownership, see Q 81, Q 174, and Q 302. See Q 170 for information on the assignment of group term insurance coverage.)

87. Can an insured remove existing life insurance from the insured's gross estate by an absolute assignment of the policy but retaining a reversionary interest?

A reversionary interest in a policy is an incident of ownership if, immediately before the insured's death, the value of the reversionary interest is worth more than 5 percent of the value of the policy.[5] The insured will have no such reversionary interest, however, if the policy is purchased and owned by another person, or if the policy is absolutely assigned to another person by the insured. Regulations state that the term "reversionary interest" does not include the possibility that a person might receive a policy or its proceeds by inheritance from another person's estate, by exercising a surviving spouse's statutory right of election, or under some similar right. They also state that, in valuing a reversionary interest, interests held by others that would affect the value must be taken into consideration. For example, a decedent would not have a reversionary interest in a policy worth more than 5 percent of the policy's value, if, immediately before the decedent's death, some other person had the unrestricted power to obtain the cash surrender value of the policy; the value of the reversionary interest would be zero.[6]

An insured was treated as holding a reversionary interest in a policy held in a trusteed buy-sell arrangement where the insured was considered to have transferred the policy to the trust and retained the right to purchase the policy for its cash surrender value upon termination of

1. Rev. Rul. 81-166, 1981-1 CB 477.
2. Treas. Regs. §§20.2042-1(b)(1), 20.2042-1(c)(1); *Lamade v. Brownell*, 245 F. Supp. 691 (M.D. Pa. 1965).
3. *Est. of Piggott v. Comm.*, 340 F.2d 829 (6th Cir. 1965).
4. *Morton v. U.S.*, 457 F2d 750, 29 AFTR 2d 72-1531 (4th Cir. 1972).
5. IRC Sec. 2042(2).
6. Treas. Reg. §20.2042-1(c)(3).

the buy-sell agreement.[1] However, a policy held in a trusteed buy-sell arrangement would not be includable in an insured's estate under IRC Section 2042 where (1) proceeds would be received by a partner's estate only in exchange for purchase of the partner's stock, and (2) all incidents of ownership would be held by the trustee of the irrevocable life insurance trust.[2]

88. Are the general rules for including life insurance proceeds in the insured's gross estate applicable to proceeds payable under a qualified pension or profit-sharing plan?

Yes, generally, for estates of decedents dying after 1984; but see Q 3877 for details.

89. May a life insurance beneficiary be required to pay estate tax attributable to death proceeds?

Yes, under either of two circumstances: (1) Where the decedent/insured has directed in his or her will that the life insurance beneficiary pay the share of death taxes attributable to the proceeds; and (2) where the state of the decedent's domicile has a statute that apportions the burden of death taxes among probate and nonprobate beneficiaries in absence of any direction from the decedent regarding where the burden of death taxes should fall.

Most states have statutes that apportion death taxes (federal, state, or both) among the beneficiaries of an estate, probate and nonprobate, under circumstances in which the decedent has not directed otherwise. A few states place the death tax burden on the probate estate (technically, the residuary estate).

A federal apportionment statute provides in pertinent part as follows: "Unless the decedent directs otherwise in his will, if any part of the gross estate on which tax has been paid consists of proceeds of policies of insurance on the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds of such policies bear to the taxable estate."[3]

In *McAleer v. Jernigan*,[4] the decedent's former wife was the beneficiary of insurance on the decedent's life. The decedent, who died domiciled in Alabama, did not direct in his will where the burden of death taxes should fall. The Alabama statute said that unless the decedent directed otherwise, the executor was to pay death taxes out of estate property (i.e., from the residuary estate). The statute also said that the executor was under no duty to recover any pro rata portion of such taxes from the beneficiary of any nonprobate property. In a suit by the executor to recover from the life insurance beneficiary a pro rata share of the estate tax due (the insurance proceeds having been found includable in the gross estate for federal estate tax purposes), the U.S. Court of Appeals for the Eleventh Circuit held that the federal statute, IRC Section 2206, prevailed over the state statute and allowed the executor to recover.

1. TAM 9349002.
2. Let. Rul. 9511009.
3. IRC Sec. 2206.
4. 804 F2d 1231, 86-2 USTC ¶13,705 (11th Cir. 1986), rev'g and remanding 86-2 USTC ¶13,704 (S.D. Ala. 1986).

90. May a life insurance beneficiary make a qualified disclaimer of an amount equal to the beneficiary's proportionate share of death taxes when the decedent directed that death taxes be paid entirely out of the probate estate?

Yes.

In *Est. of Boyd v. Comm.*,[1] in an unusual fact situation, the decedent's son was left the entire probate estate, $153,000, plus $389,000 of life insurance proceeds (as named beneficiary). The decedent's second wife (the son's step-mother) received nothing. The decedent's will directed his executor to pay out of the probate estate the tax (an estimated $78,000) allocable to the life insurance proceeds. The son disclaimed the entire probate estate *and* any right to have the probate estate pay any death tax attributable to the life insurance proceeds. The IRS refused to give effect to the second disclaimer, which had the effect of reducing the amount of marital deduction the estate claimed. The disclaimer statute says that a qualified disclaimer means an irrevocable and unqualified refusal to accept an *interest in property*. The court recognized the subject of the second disclaimer as an interest in property for purposes of the statute and allowed the claimed marital deduction.

Planning Point: Remember that under IRC Sec. 2518 and many state statutes, a disclaimer is qualified only if (among several other requirements) no portion of the disclaimed interest passes to the disclaiming party as a result of the disclaimer. It is important to consider where the disclaimed interest passes after the disclaimer is made.

91. When are death proceeds of life insurance that were given away by an insured within three years of the insured's death includable in the insured's gross estate?

Proceeds are automatically includable in the insured's gross estate without regard to the insured's motives in making the gift.[2] Also includable is the amount of any gift tax paid by the decedent or the decedent's estate on the transfer.[3] The provision that excepts from includability gifts as to which the decedent was not required to file a gift tax return does not apply to a "transfer with respect to a life insurance policy."[4] The quoted language, part of the amendment of IRC Section 2035 made by the Revenue Act of 1978, seems broad enough to include gifts of both policies and premium payments. (However, committee reports explaining the provision indicate that it was not the intention to treat as a "transfer with respect to a life insurance policy" any gifts of premium payments made more than three years after the donor has made a gift of the policy. See Congressional committee explanation of Section 702(f) of the Revenue Act of 1978.) (See Q 170 for special rules applicable to group insurance.)

When the insured makes a gift of the policy within three years of death, the value of any premiums the insured pays gratuitously after making the gift is not added to the proceeds

1. 819 F2d 170, 87-1 USTC ¶13,720 (7th Cir. 1987), rev'g 85 TC 1056 (1985).
2. IRC Sec. 2035.
3. IRC Sec. 2035(b).
4. IRC Sec. 2035(c)(3).

includable in the insured's estate.[1] Courts had held under earlier versions of IRC Section 2035 that if any premiums paid after the transfer are paid by the donee rather than by the insured, only proceeds in the ratio of premiums paid by the donor to total premiums paid are includable in the donor's estate.[2] The proportional proceeds rule where the donee pays premiums after the transfer also has been applied to deaths occurring after 1981 even though payment of premiums no longer determines includability of proceeds under the transfers within the three years of death rule.[3] If premiums are paid from property owned jointly by the decedent and donee, the burden is on the donee to prove the extent to which the premiums were paid out of property originally owned by the donee.[4]

For the bringback rule of Section 2035 to apply when a policy is purchased on the initiative of the insured with funds provided by the insured, a third party is designated owner of the policy, and the insured dies within three years of the purchase, there would have to be a transfer for purposes of IRC Sections 2036, 2037, 2038, or 2042.

Courts have determined that insurance proceeds are not included in an insured's estate, even though death occurred within three years of the policy purchase, if the policy is owned by a third party, the policy is not made payable to the insured's estate, and the insured held no incidents of ownership in the policy under IRC Section 2042.[5] Indeed, attorney fees were awarded to the taxpayers in the *Perry* case because the position of the United States was not substantially justified.[6] Due to the adverse court decisions, the IRS has announced that it will no longer litigate its position (although it still believes that substance should prevail over form and that the "beamed transfer" theory should be applied to such "indirect transfers" of life insurance within three years of death).[7]

In TAM 9323002, life insurance proceeds were not included in an insured's estate where:

(1) the insured applied for the policy,

(2) the insured then had the policy split into two policies and named her two sons as owners and beneficiaries prior to paying any premiums,

(3) the insured's sons paid all premiums, and

(4) the insured died within three years of purchase of the policy.

The memorandum determined that under the terms of the contract and state law, no contract existed before the first premium was paid and the life insurance contract was issued and delivered. The memorandum also concluded that although it appeared that the decedent

1. *Peters v. U.S.*, 572 F 2d 851, 78-1 USTC ¶13,239 (Ct. Cl. 1978).
2. *Liebmann v. Hassett*, 148 F.2d 247 (1st Cir. 1945); *Est. of Silverman v. Comm.*, 61 TC 338 (1973), aff'd 521 F.2d 574 (2nd Cir. 1975); Treas. Reg. §20.2035-1(e).
3. *Est. of Friedberg v. Comm.*, TC Memo 1992-310; TAM 9128008.
4. *Peters v. U.S.*, above.
5. *Est. of Leder v. Comm.*, 893 F2d 237, 90-1 USTC ¶60,001 (10th Cir. 1989); *Est. of Headrick v. Comm.* 918 F2d 1263, 90-2 USTC ¶60,049 (6th Cir. 1990); *Est. of Perry v. Comm.*, 927 F2d 209, 91-1 USTC ¶60,064 (5th Cir. 1991).
6. *Est. of Perry v. Comm.*, 91-1 USTC ¶60,073 (5th Cir. 1991).
7. AOD 1991-012.

passed something of value to her two sons (i.e., although the insurance company's premium rates had increased between the first and second step, the earlier lower premium rates were obtained by the sons), it was unlikely that such transfer constituted a transfer of incidents of ownership.

An exchange of policies by an irrevocable trust was not treated as a transfer within three years of death where the original transfer of the policy had occurred more than three years before death, the decedent had no interest in the policy at the time of the exchange, and the decedent's signature was not essential to the exchange.[1] The decedent-insured did not transfer the policy within three years of death, even though the policy was amended within three years of death to provide that a trust, rather than the decedent, was the owner, where the intent of the parties clearly indicated through extrinsic evidence that the decedent had ceased being the owner of the policy more than three years before death.[2]

92. Is life insurance owned by a corporation on its majority shareholder included in the shareholder's estate when the shareholder divested an interest in the corporation within three years of death?

Life insurance owned by a corporation on its majority shareholder was not included in the shareholder's estate where the shareholder sold her interest in the corporation within three years of death. The corporation had always owned the policy, paid the premiums, and been beneficiary of the proceeds.[3] However, where a majority shareholder reduced his interest in a corporation to 40 percent within three years of death and proceeds of life insurance owned by the corporation on such shareholder were payable to the shareholder's daughter, proceeds were included in the shareholder's estate.[4] Also, where a corporation transferred a life insurance policy to the beneficiary within three years of the controlling shareholder's death, proceeds were included in the controlling shareholder's estate even though the shareholder transferred his interest in the corporation to his son after the corporation's transfer of the life insurance policy and prior to his death.[5] (See also Q 302.) Where a non-majority shareholder held the right to purchase a policy on his life from a corporation upon termination of a buy-sell agreement and the shareholder caused the corporation to transfer the policy to an irrevocable trust within three years of the shareholder's death, the proceeds were included in the shareholder's estate.[6]

93. Are there any situations in which death proceeds of life insurance that were given away by an insured within three years of the insured's death are not included in the insured's gross estate?

An exception is provided to the transfers within three years of death rules for any bona fide sale for adequate and full consideration.[7] It is unclear whether consideration equal to the

1. TAM 8819001.
2. Let. Rul. 9651004.
3. Let. Rul. 8906002.
4. Rev. Rul. 90-21, 1990-1 CB 172, situation 2.
5. Rev. Rul. 90-21, 1990-1 CB 172, situation 1.
6. TAM 9127007.
7. IRC Sec. 2035(d).

interpolated terminal reserve of a policy plus any unexpired premiums is adequate to avoid the transfers within three years of death rule. TAM 8806004 interpreted full consideration as requiring that the consideration must be adequate relative to what would be included in the estate (i.e., the proceeds), not relative to what is transferred (i.e., the policy). See *Est. of Pritchard v. Comm.*,[1] where consideration equal to the cash surrender value was inadequate. However, TAM 9413045 accepted the interpolated terminal reserve plus any unexpired premiums as adequate consideration.

94. If a donor dies within three years of making a gift of a life insurance policy the donor owned on the life of another, is the value of the policy includable in the donor's gross estate?

No. IRC Section 2035 brings back into a decedent's estate certain gifts made within three years of death. The bring-back rule of Section 2035 applies to a transfer of an interest in property that is included in the value of the gross estate under IRC Sections 2036, 2037, 2038, or 2042, or would have been included under any of these sections if such interest had been retained by the decedent. IRC Section 2042 has to do with proceeds of insurance *on the life of the decedent*.

IRC Section 2033 governs whether the value of a policy owned by the decedent on the life of *another* is includable in the decedent's estate. A transfer of an interest in property included in the value of the gross estate under Section 2033, or that would have been included under Section 2033 if the interest had been retained by the decedent, is not among the enumerated sections under the bring-back rule of Section 2035. Thus, the value of a policy owned by a decedent on the life of another and transferred by the decedent within three years of the decedent's death (occurring after 1981) will not normally be brought back into the decedent's estate under Section 2035.

95. If an employer provides, under a nonqualified agreement or plan, an income benefit only for certain survivors designated by family or marital relationship to the employee, how is the benefit treated for estate tax purposes in the employee's estate?

The threshold issue is whether the survivor income benefit plan is treated as insurance or as an annuity (see Q 243 for background).

If it is treated as life insurance, includability of the value of the survivor benefit in the employee's estate is determined under the rules applicable to death proceeds of insurance. The controlling statute in this case is usually IRC Section 2042, although IRC Section 2035 also comes into play if the decedent-insured has assigned any rights in the benefit within three years of death (Q 76, Q 169). If the plan is treated as an annuity, includability is usually determined under IRC Section 2039(a), but not under IRC Section 2042 (see Q 96 and Q 97 particularly the discussion of death-benefit-only plans in Q 97).

1. 4 TC 204 (1944).

Case law and IRS rulings dealing with the estate taxation of survivor income benefits tend to support the view of the U.S. Court of Appeals for the Second Circuit. In *All v. McCobb*,[1] the Second Circuit held that a survivor income benefit plan that was uninsured and unfunded lacked the necessary insurance elements of risk-shifting and risk-distribution to be treated as insurance. (See also the cases cited at Q 243.) *Est. of Lumpkin v. Comm.*,[2] *Est. of Connelly v. U.S.*,[3] and *Est. of Smead v. Comm.*[4] all involve insured plans that the courts treated as group insurance.

In Letter Ruling 8046110, a plan funded by group life insurance was treated as insurance. Following Revenue Ruling 69-54 (Q 171), the IRS ruled that because the decedent insured died possessing the right to convert his group life insurance into individual insurance, an incident of ownership, the sum used by the insurance company in determining the amount of the survivor annuity payable was includable in the decedent's estate.[5] Revenue Ruling 77-183,[6] *Est. of Schelberg v. Comm.*,[7] and *Est. of Van Wye v. U.S.*,[8] all involved uninsured and unfunded plans that the courts treated as annuities.

No estate tax cases or rulings have been found that deal with *uninsured funded* plans (but see Q 243).

96. Is the value of a survivor benefit payable by an employer under a nonqualified salary continuation or deferred compensation agreement includable in the employee's gross estate?

Yes, it is includable under IRC Section 2039(a) if (1) it is provided for "under any form of contract or agreement," and (2) the decedent had a right to receive the payments for life, for any period not ascertainable without reference to the decedent's death, or for any period that does not in fact end before the decedent's death.

The statute applies where the decedent was receiving payments and had a nonforfeitable right to future payments at the time of death. Regulations make it equally clear, however, that the IRS will consider the statute applicable whether the decedent had a right to present or future payments at the time of death and whether the rights were forfeitable or nonforfeitable.

The regulations provide: "The term 'contract or agreement' includes any arrangement, understanding or plan, or any combination of arrangements, understandings or plans arising by reason of the decedent's employment."[9] Although the Tax Court has stated that an enforceable contract is a prerequisite to the application of IRC Section 2039,[10] later case law has led to

1. 321 F.2d 633 (2nd Cir. 1963).
2. 474 F.2d 1092 (5th Cir. 1973).
3. 551 F.2d 545 (3rd Cir. 1977).
4. 78 TC 43 (1982), acq. in result, 1984-2 CB 2.
5. See Treas. Reg. §20.2042-1(a)(3).
6. 1977-1 CB 274.
7. 70 TC 690 (1978), rev'd on other grounds, 79-2 USTC ¶13,321 (2nd Cir. 1979).
8. 686 F2d 425. 82-2 USTC ¶13,485 (6th Cir. 1982).
9. Treas. Reg. §20.2039-1(b).
10. *Est. of Barr v. Comm.*, 40 TC 227 (1963), acq. in result only, 1978-1 CB 1.

a less rigid rule. When there is no legally enforceable contract, other circumstances may exist that would cause an annuity to be considered as having been paid under a contract or agreement for purposes of the statute. Thus, if the survivor annuitant has a controlling interest in the company, if consideration for the annuity is found, or if the company has in the past consistently paid annuities pursuant to an unenforceable plan, the annuity may be considered as having been paid under a contract or agreement; if no such circumstances are found, a legally enforceable contract must exist.[1]

It has been argued that payments under a deferred compensation contract have no estate tax value if they were forfeitable to the executive during his or her lifetime. This argument is based on the theory that the estate tax value is to be determined as of the moment prior to death. However, it is now rather firmly established that the value is to be determined as of the moment after death when the contingencies have ceased to have an operative effect.[2] In *Silberman v. U.S.*,[3] the commuted value of the widow's benefit was includable in the employee's estate even though the employee had to render consulting services to get retirement benefits.

The estate tax cannot be avoided by providing for the retirement pay and death benefit under separate contracts; IRS regulations interpret the statutory term "contract or agreement" to include "any combination of arrangements, understandings or plans arising by reason of the decedent's employment."[4]

The death benefit is includable in the gross estate whether it is payable in a lump sum or in periodic payments, and whether it is forfeitable or nonforfeitable to the survivor. Forfeitability will be taken into account in connection with the valuation of the benefit in the employee's estate.[5] For example, where the employer has a right to recover remaining unpaid benefits upon the death or remarriage of the employee's surviving spouse, the value of the death benefit in the employee's estate will not include the value of this refund feature.[6] (Such a forfeiture provision, however, would make the benefit ineligible for the marital deduction.) When the death benefit is payable as an annuity, the commuted value of the payments is the proper estate tax value.[7] The commuted value of annuity payments is determined by use of the Estate and Gift Tax Valuation Tables.

Thus, a widow's benefit under a typical deferred compensation agreement is includable in the gross estate by reason of IRC Section 2039(a). Even if it were not includable under IRC Section 2039(a), however, it probably would be includable under one of the other estate tax sections.[8]

1. *Neely v. U.S.*, 613 F.2d 802 (Ct. Cl. 1980); *Courtney v. U.S.*, 54 AFTR 2d 84-6492 (N.D. Ohio, 1984). See also Let. Rul. 8005011.
2. *Goodman v. Granger*, 243 F.2d 264 (3rd Cir. 1957).
3. 28 AFTR 2d 6282 (W.D. Pa. 1971).
4. Treas. Reg. §20.2039-1(b).
5. Treas. Reg. §20.2039-1(b)(2)(Ex. 2).
6. *Allen v. Comm.*, 39 TC 817 (1963), acq. 1964-1 CB 4.
7. *Est. of Beal v. Comm.*, 47 TC 269 (1966), acq. 1967-2 CB 1.
8. See *Goodman v. Granger*, 243 F.2d 264; *Est. of Leoni v. Comm.*, 7 TCM (CCH) 759 (1948); *Est. of Davis v. Comm.*, 11 TCM (CCH) 814 (1952); Rev. Rul. 260, 1953-2 CB 262.

97. When is the value of a survivor benefit payable by an employer under a nonqualified salary continuation or deferred compensation agreement excludable from the employee's gross estate?

Under certain circumstances, an unfunded deferred compensation agreement that provides death benefits only may escape inclusion in the employee's gross income. If the employee has no right to any post-employment retirement or disability benefits, other than benefits under a qualified pension or profit-sharing plan (that is, only a pure survivor benefit is provided), the benefit is not subject to estate tax under IRC Section 2039(a).[1] In determining whether the deceased employee had any post-employment benefits, all rights and benefits accruing to the employee and others by reason of the employee's employment (except those under a qualified pension or profit-sharing plan) will be treated as one contract or plan under IRC Section 2039(a).[2]

The section cannot be avoided, for instance, by providing lifetime benefits under one agreement, and the death benefit under another.[3] However, courts have held that the mere fact that at death the employee was covered under a plan that, had the employee lived and been found totally and permanently disabled sometime in the future, would have paid the employee benefits, was not sufficient to bring the value of the survivor benefit under a death-benefit-only ("DBO") plan into the employee's estate under IRC Section 2039(a).[4] The IRS has announced that it will follow this decision in all circuits.[5] If the agreement provides for payments to the employee after the employee becomes too incapacitated to perform services, or requires only nominal services after a certain age, payments will be treated as postretirement benefits of the employee.[6] On the other hand, if substantial services are necessary to receive the payments, the payments have been held to be salary rather than retirement or disability benefits.[7] Similarly, a plan paying a wage-related benefit and designed to provide for disability resulting in only a temporary absence from work is considered to pay benefits in the nature of salary, not a post-employment benefit.[8]

A pure survivor benefit is not includable in a decedent's gross estate under IRC Section 2033 because no interest is held by the decedent at death.[9] Nonetheless, under certain circumstances the value of a pure survivor benefit may be included in a decedent's gross estate under other estate tax provisions.

1. *Est. of Fusz v. Comm.*, 46 TC 214 (1966), acq. 1967-2 CB 2; Rev. Rul. 76-380, 1976-2 CB 270.
2. Treas. Reg. §20.2039-1(b).
3. Treas. Reg. §20.2039-1(b)(2)(Ex. 6); *Est. of Beal v. Comm.*, supra; *Gray v. U.S.*, 410 F.2d 1094 (3rd Cir. 1969).
4. *Est. of Schelberg v. Comm.*, 612 F 2d 25, 79-2 USTC ¶13,321 (2nd Cir. 1979), rev'g 70 TC 690 (1978); *Est. of Van Wye v. U.S.*, 686 F 2d 425, 82-2 USTC ¶13,485 (6th Cir. 1982).
5. *Looney v. U.S.*, Docket No. 83-8709 (11th Cir., motion filed 1-26-84).
6. *Silberman v. U.S.*, 333 F. Supp. 1120 (W.D. Pa. 1971); *Gaffney v. U.S.*, 200 Ct. Cl. 744 (1972); *Hetson v. U.S.*, 75-2 USTC 13,098 (Ct. Cl. 1975).
7. *Kramer v. U.S.*, 406 F.2d 1363 (Ct. Cl. 1969).
8. Rev. Rul. 77-183, 1977-1 CB 274; *Est. of Siegel v. Comm.*, 74 TC 613 (1980); see also *Est. of Schelberg* and *Est. of Van Wye*, above.
9. *Kramer v. U.S.*, 406 F.2d 1363 (Ct. Cl. 1969); *Est. of Porter v. Comm.*, 442 F.2d 915 (1st Cir. 1971); *Hinze v. U.S.*, 29 AFTR 2d 1553 (C.D. Cal. 1972); *Harris v. U.S.*, 29 AFTR 2d 1558 (C.D. Cal. 1972); see also *Worthen v. U.S.*, 192 F. Supp. 727 (D. Mass. 1961).

Courts have ruled that by giving consideration (e.g., agreeing to continue in the company's employ) for the survivorship benefit, a decedent makes a transfer of the benefit to the survivor.[1] If the decedent holds a reversionary interest of more than 5 percent of the value of the benefit, its value is includable under IRC Section 2037.[2] If the decedent retains the power to alter, amend, revoke, or terminate the agreement or to change the beneficiary, either alone or with the consent of the employer or someone else, the value could be included under IRC Sections 2036 and 2038.[3] Generally, the mere possibility that an employee could (i) negotiate a new agreement with his or her employer, (ii) exert influence as an officer, shareholder, or director to secure desired changes, or (iii) terminate the plan by terminating employment, has not been held a retention of such powers.[4]

In TAM 8701003, which concerned a DBO plan between a corporation and its controlling stockholder, the IRS agreed with the reasoning in the *Kramer*, *Hinze*, and *Harris* cases cited above and concluded that the stockholder-employee's voting power did not give the stockholder-employee rights that would make the value of the death benefit includable in his estate under IRC Sections 2036 or 2038. However, in *Est. of Levin v. Comm.*,[5] an annuity payable under a DBO plan was included in the estate of the deceased controlling shareholder and chair of the board under IRC Section 2038 because the decedent was considered to have held until his death the right to amend or revoke an annuity payable by the corporation to his wife if he should die while still in the employ of the controlled corporation and if certain eligibility requirements (tailor-made for the decedent) were met.

For the gift tax implications of DBO plans, see Q 212.

Voluntary Payments

If the payment is not made under a contract or plan, but is purely voluntary on the part of the employer, it is not subject to tax in the employee's estate.[6]

Generation-Skipping Transfer Tax Issues

98. Can arrangements for payment of the proceeds of life insurance and annuity contracts attract the generation-skipping transfer tax?

Yes. Regardless of what form an arrangement may take (whether, for example, the arrangement is a life insurance trust, an agreement with the insurer for payment of proceeds under settlement options, or an outright payment to a beneficiary), if an insured (or annuitant) transfers benefits to a "skip person," generally, the insured has made a generation-skipping transfer.

1. *Est. of Fried v. Comm.*, 445 F.2d 979 (2nd Cir. 1971); *Est. of Porter v. Comm.*, supra; *Est. of Bogley v. U.S.*, 206 Ct. Cl. 695 (1975); see also *Worthen v. U.S.*, supra and *Molter v. U.S.*, 146 F. Supp. 497 (E.D. N.Y. 1956); however, for a contrary view, see *Hinze v. U.S.*, supra, and *Harris v. U.S.*, supra.
2. *Est. of Fried v. Comm.*, supra; *Est. of Bogley v. U.S.*, supra; Rev. Rul. 78-15, 1978-1 CB 289; Let. Rul. 7802002.
3. Rev. Rul. 76-304, 1976-2 CB 269; *Est. of Siegel v. Comm.*, 74 TC 613 (1980); Let. Rul. 8943082.
4. *Kramer v. U.S.*, supra; *Est. of Whitworth v. Comm.*, TC Memo 1963-41; *Hinze v. U.S.*, supra; *Harris v. U.S.*, supra; Let. Rul. 7827010.
5. 90 TC 723 (1988).
6. *Est. of Barr v. Comm.*, 40 TC 227 (1963), acq. in result only, 1978-1 CB 1; *Est. of Albright v. Comm.*, 42 TC 643 (1964); *Est. of Morrow v. Comm.*, 19 TC 1068 (1953), acq. 1954-1 CB 5, nonacq. 1979-2 CB 2; *Garber v. Comm.*, TC Memo 1958-121; *Worthen v. U.S.*, supra; *Est. of Bogley v. U.S.*, supra.

For purposes of the generation-skipping transfer (GST) tax, the term "trust" includes any arrangement (such as life estates, estates for years, and insurance and annuity contracts) other than an estate that, although not a trust, has substantially the same effect as a trust.[1] In the case of an arrangement that is not a trust but that is treated as a trust, the term "trustee" means the person in actual or constructive possession of the property subject to such arrangement.

The IRS has been given authority to issue regulations that may modify the generation-skipping rules when applied to trust equivalents, such as life estates and remainders, estates for years, and insurance and annuity contracts.[2] The committee report states that such authority, for example, might be used to provide that the beneficiary of an annuity or insurance contract be required to pay any GST tax.

Regulations provide that the executor is responsible for filing and paying the GST tax if (1) a direct skip occurs at death, (2) the property is held in a trust arrangement, which includes arrangements having the same effect as an explicit trust, and (3) the total value of property subject to the direct skip is less than $250,000. The executor is entitled to recover the GST tax attributable to the transfer from the trustee (if the property continues to be held in trust) or from the recipient of the trust property (if transferred from the trust arrangement).

Regulations provide a number of examples that treat insurance proceeds as a trust arrangement. Where insurance proceeds held by an insurance company are to be paid to skip persons in a direct skip at death (a direct skip can occur whether proceeds are paid in a lump sum or over a period of time) and the aggregate value of such proceeds held by the insurer is less than $250,000, the executor is responsible for filing and paying the GST tax. Consequently, the insurance company can pay out the proceeds without regard to the GST tax (apparently, the insurance company could not do so if the executor attempts to recover the GST tax while the company still holds proceeds). When the value of the proceeds in the aggregate equals or exceeds $250,000, however, the insurance company is responsible for filing and paying the GST tax.[3]

99. Can the transfer to an irrevocable life insurance trust of an amount used to make premium payments qualify for the generation-skipping transfer tax annual exclusion?

Yes.

If certain requirements are met, a transfer to an irrevocable life insurance trust can qualify for the annual exclusion (and thus avoid the generation-skipping transfer (GST) tax). A nontaxable gift, which is a direct skip, has an inclusion ratio of zero (i.e., it is not subject to GST tax). Nontaxable gifts are defined as gifts eligible for the annual exclusion (see Appendix D for amounts) (doubled if gifts are split between spouses), as well as certain transfers for educational or medical expenses. However, with respect to transfers after March 31, 1988,

1. IRC Sec. 2652(b).
2. IRC Sec. 2663(3).
3. Treas. Reg. §26.2662-1(c)(2).

the nontaxable gift that is a direct skip to a trust for the benefit of an individual has an inclusion ratio of zero only if (1) during the life of such individual no portion of the trust corpus or income may be distributed to or for the benefit of any other person, and (2) the trust would be included in such individual's estate if the trust did not terminate before such individual died.[1] Thus, separate shares or separate trusts, as described in the preceding sentence, must be created for each such individual if premium payments are to be covered by the annual exclusion for GST tax purposes.

Planning Point: Because of the separate share requirement, the annual exclusion is generally not used for generation-skipping life insurance trusts. Instead, the trust is usually protected by allocating the GST exemption to all transfers to the trust.

100. How can the generation-skipping transfer (GST) tax exemption be leveraged using an irrevocable life insurance trust?

Leveraging of the GST tax exemption (see Appendix D) can be accomplished by allocating the exemption against the discounted dollars that the premiums represent when compared with the ultimate value of the insurance proceeds. However, in the case of inter vivos transfers in trust, allocation of the GST exemption is postponed until the end of an estate tax inclusion period (ETIP).[2] In general, an ETIP would not end until the termination of the last interest held by either the transferor or the spouse of the transferor during the period in which the property being transferred would have been included in either spouse's estate if that spouse died.

Of course, the transferor should be given no interest that would cause the trust property to be included in the transferor's estate. Furthermore, the transferor's spouse should be given no interest that would cause the trust property to be included in the transferor spouse's estate if the transferor spouse were to die.

The property is not considered as includable in the estate of the spouse of the transferor by reason of a withdrawal power limited to the greater of $5,000 or 5 percent of the trust corpus if the withdrawal power terminates no later than sixty days after the transfer to the trust.[3] Also, the property is not considered as includable in the estate of the transferor or the spouse of the transferor if the possibility of inclusion is so remote as to be negligible (i.e., less than a 5 percent actuarial probability).[4] Furthermore, the ETIP rules do not apply if a reverse qualified terminable interest property (QTIP) election is made.[5] Otherwise, if proceeds are received during the ETIP, the allocation of the GST exemption must be made against proceeds rather than premiums and the advantage of leveraging is lost.

> *Example 1*. [Twenty years in this example only is based upon the $1 million GST exemption prior to any inflation or other adjustment after 1998.] G creates a trust for the benefit of his children and grandchildren. Each year he transfers to the trust $50,000 (to be used to make premium payments on a $2 million

1. IRC Sec. 2642(c).
2. IRC Sec. 2642(f).
3. Treas. Reg. §26.2632-1(c)(2)(ii)(B).
4. Treas. Reg. §26.2632-1(c)(2)(ii)(A).
5. Treas. Reg. §26.2632-1(c)(2)(ii)(C).

insurance policy on his life) and allocates $50,000 of his GST exemption to each transfer. Assuming G makes no other allocations of his GST exemption, the trust will have a zero inclusion ratio (i.e., it is not subject to GST tax) during its first twenty years. At the end of twenty years, G will have used up his GST exemption and the trust's inclusion ratio will increase slowly with each additional transfer of $50,000 to the trust. If G died during the twenty-year period, the insurance proceeds of $2 million would not be subject to GST tax. Part of the $2 million proceeds may be subject to GST tax if G died in a later year. To ensure that the trust has a zero inclusion ratio, use of a policy that becomes paid-up before the transfers to trust exceed the GST exemption may be indicated.

Example 2. Same facts as in Example 1, except that the trust is created for G's spouse, S, during her lifetime, and then, to benefit children and grandchildren. If the trust is intended to qualify for the marital deduction (apparently, other than if a reverse QTIP election is used), the valuation of property for purpose of the ETIP rule is generally delayed until G or S dies because the property would have been included in S's estate if she died during the ETIP. Consequently, if the $2 million insurance proceeds are received during the wife's lifetime, the GST exemption is allocated against the $2 million proceeds, and a substantial amount of GST tax may be due upon subsequent taxable distributions and taxable terminations from the trust. Because allocation of the exemption must be made against the proceeds if they are received during the ETIP, the advantage of leveraging enjoyed in Example 1 is lost.

NOTE: The 2011 $5 million GST tax lifetime exemption was inflation-adjusted to $5.12 million in 2012, $5.25 million in 2013 and $5.34 million in 2014. The 2010 Tax Relief Act also unified the lifetime gift exemption with the estate tax exemption.[1] The American Taxpayer Relief Act of 2012 (ATRA 2012) made this unification permanent, so that the $5 million lifetime exemption will continue to be indexed annually for inflation (as noted above, the inflation-adjusted amount for 2014 is $5.34 million). This increased exemption will provide transferors with flexibility in funding life insurance premiums through irrevocable life insurance trusts as it allows the transferor to front-pay premium payments with the unused portion of the $5 million exemption ($10 million for married couples), as indexed. In addition, ATRA 2012 made the portability of unused exemptions among spouses permanent, so that any unused exemption of a spouse who dies in a tax year beginning after 2010 may be used by the surviving spouse.[2] (See Q 711).

Divorce

101. What are the income tax results when an individual transfers an existing life insurance policy to or purchases a policy for the individual's former spouse in connection with a divorce settlement?

IRC Section 1041 Transfer of Policy

No gain generally is recognized by the transferor if an existing policy is transferred to a spouse, or former spouse incident to a divorce, after July 18, 1984, unless the transfer is pursuant to an instrument in effect on or before such date or the transfer is, under certain circumstances, in trust.

When no gain is recognized, the transferee will be treated as having acquired the policy by gift and the transferor's cost basis for the policy (net premiums paid) is carried over to the transferee.[3] In addition, any such transfer of an existing policy will not cause the proceeds to be

1. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Section 302(b)(1), Pub. Law 111-312 (2010), amending 26 U.S.C. §2505(a). See also, The American Taxpayer Relief Act of 2012, Public Law 112-240, Rev. Proc. 2013-15.
2. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Section 303(b)(1), Pub. Law 111-312 (2010), amending 26 U.S.C. §2010(c)(4). See also, The American Taxpayer Relief Act of 2012, Public Law 112-240, Rev. Proc. 2013-15.
3. IRC Sec. 1041.

includable in the income of the transferee under the transfer for value rule (Q 74). A transfer is incident to a divorce if the transfer occurs within one year after the date the marriage ceases or is related to the cessation of the marriage.[1] Thus, a transfer of property occurring not more than one year after the date on which the marriage ceased need not be related to the cessation of the marriage to qualify for Section 1041 treatment. A transfer of a policy is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument and the transfer occurs not more than six years after the date on which the marriage ceases.[2]

If property is transferred in trust for the benefit of the spouse or former spouse, however, gain will be recognized by the transferor to the extent that the sum of the liabilities assumed plus the amount of liabilities to which the property is subject exceed the total of the adjusted basis of all property transferred. Therefore, when a policy with a loan is transferred in trust, gain will be recognized to the extent the total liabilities of all property transferred to the trust exceed the total basis of all items of property transferred. When gain is recognized on a transfer in trust, the transferee's basis is adjusted to reflect the amount of gain recognized by the transferor. Payments from an insurance trust to which the property is transferred for the benefit of a spouse or former spouse will be taxed to the spouse or former spouse as a beneficiary and not taxed as alimony.[3]

Both spouses or both former spouses may elect to have these rules apply to all transfers after 1983 and also may elect to have these rules apply to transfers after July 18, 1984, under divorce or separation instruments in effect before July 19, 1984.

102. What is the tax treatment of other transfers of an existing life insurance policy in connection with a divorce settlement to which the nonrecognition rules do not apply?

If an existing policy was transferred before July 19, 1984, or after July 18, 1984 pursuant to an instrument in effect prior to such date (and no election is made to have the IRC Section 1041 nonrecognition rules apply), then the following rules apply.

If the fair market value of the policy at the time of transfer exceeds the transferor's cost basis for the policy (net premiums paid), the transferor may have some taxable gain. (For fair market value, see Q 139.) In *Comm. v. Davis*,[4] the U.S. Supreme Court held that a transfer of property by a husband in exchange for his wife's relinquishment of her marital rights is a taxable exchange, and the value of the marital rights exchanged is equal to the fair market value of the property at time of transfer. The *Davis* rule apparently would apply to such a transfer involving a life insurance policy.

The value of the policy transferred would not be taxable to the transferee and would not be deductible by the transferor.[5] The same results would follow if a spouse purchased a single

1. Temp. Treas. Reg. §1.1041-1T, A-6.
2. Temp. Treas. Reg. §1.1041-1T, A-7.
3. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at p. 711.
4. 370 U.S. 65 (1962).
5. *Ashcraft v. Comm.*, 252 F.2d 200 (7th Cir. 1958), aff'g 28 TC 356 (1957).

premium policy for the spouse's former spouse pursuant to the divorce settlement.[1] These values are not taxable to the recipient and deductible by the payor because they represent single sum payments rather than periodic payments of alimony.

Transfer of an existing policy can result in adverse tax consequences to the former spouse. If the policy is assigned to the former spouse, the proceeds are received as life insurance proceeds and not as alimony income. However, it would seem that the former spouse is a purchaser for value and, consequently, the proceeds would be subject to the transfer for value rule (Q 72, Q 74).[2] Hence, the profit (the excess of the proceeds over the value of the contract on the date of transfer plus all premiums and certain other amounts paid thereafter) would be taxable to the former spouse as ordinary income.[3]

103. What is the tax treatment when an existing life insurance policy is owned and maintained by a former spouse?

If the policy is not transferred but the former spouse is required, under the divorce decree or agreement, to own and maintain a policy as security for post-death payments, installment payments of the proceeds would be taxable as alimony to the recipient spouse. Payments from an insurance trust that is established to discharge post-death obligations are fully taxable to the recipient spouse.[4]

104. If an individual is required by a court decree or separation agreement to pay premiums on a life insurance policy for a former spouse, are the premiums taxable income to the recipient spouse? Are they deductible by the payor spouse?

Premiums Paid Pursuant to Instruments Executed After 1984

Assuming that all the other alimony requirements are met, premiums paid by the payor spouse for term or permanent life insurance on the payor spouse's life pursuant to a divorce or separation instrument executed after December 31, 1984, qualify as alimony payments on behalf of the recipient spouse to the extent that the recipient spouse is the owner of the policy.[5] Premium payments that qualify as alimony payments generally are deductible by the payor spouse.[6]

Premiums Paid Pursuant to Instruments Executed Before 1985

If an existing policy is absolutely assigned to a recipient spouse, or a new policy that gives full ownership rights is purchased for the recipient spouse, the premiums are includable in the recipient spouse's gross income and are deductible by the spouse who assigned or purchased

1. *Morrison v. Comm.*, TC Memo 1956-146.
2. See *Comm. v. Davis*, supra.
3. IRC Sec. 101(a)(2).
4. IRC Sec. 71; IRC Sec. 682; Treas. Regs. §§1.71-1(c)(2), 1.101-5.
5. Temp. Treas. Reg. §1.71-1T, A-6.
6. See IRC Sec. 215.

the policy.[1] This is the result even though, under the terms of the decree or agreement, (1) the payor's obligation to pay premiums will cease upon the remarriage of the recipient spouse,[2] (2) the recipient spouse's rights in the insurance terminate if the recipient spouse does not survive the payor spouse, or (3) the recipient spouse's exercise of ownership rights is subject to the approval of the divorce court.[3]

If the payor spouse retains ownership rights in the policy, or if the recipient spouse's interest is contingent (as where the policy itself or the right to name the beneficiary will revert to the payor upon the recipient spouse's death or remarriage), the premiums are not taxable to the recipient spouse and are not deductible by the payor.[4]

It is not sufficient that the decree or agreement requires that the recipient spouse is to remain primary beneficiary; the payor spouse must give up all ownership and control.[5] A voluntary assignment not required by the decree or agreement is also not sufficient.[6] Payments are not deductible alimony taxable to a recipient spouse where a policy is assigned to a trust that confers only a lifetime interest and the children are remaindermen.[7] When the policy is placed in escrow merely as security for the payor's obligation to pay alimony, it is clear, under the foregoing rules, that the premiums are neither taxable to the recipient nor deductible by the payor.[8]

The Tax Court has held that even though a policy is assigned absolutely to the recipient spouse and the payor spouse is required to pay premiums, if the policy is *term* insurance, the premiums are neither includable in the recipient's income nor deductible by the payor.[9] The result is the same even when the term policy has a conversion privilege, if the recipient would have to pay the additional premium on conversion.[10]

Similarly, a payor spouse's policy loan repayments required by a separation agreement are not taxable to the recipient spouse, nor deductible by the payor, when the payor retains ownership of the policy and the recipient is the irrevocable beneficiary only until death or remarriage.[11]

The payor spouse's deduction, provided by IRC Section 215, is based on the inclusion of the same item in the recipient's gross income under IRC Section 71.[12]

1. See, e.g. *Carmichael v. Comm.*, 14 TC 1356 (1950); Rev. Rul. 70-218, 1970-1 CB 19.
2. *Hyde v. Comm.*, 301 F.2d 279 (2nd Cir. 1962).
3. *Stevens v. Comm.*, 439 F.2d 69 (2nd Cir. 1971).
4. See e.g. *Kiesling v. Comm.*, 349 F.2d 110 (3rd Cir. 1965); *Sperling v. Comm.*, TC Memo 1982-681.
5. Rev. Rul. 57-125, 1957-1 CB 27; *Greenway v. Comm.*, TC Memo 1980-97.
6. *Cole v. U.S.*, 76-1 USTC ¶9256 (E.D. Ill. 1975).
7. *Kinney v. Comm.*, TC Memo 1958-209.
8. *Blumenthal v. Comm.*, 183 F.2d 15 (3rd Cir. 1950).
9. *Brodersen v. Comm.*, 57 TC 412 (1971).
10. *Wright v. Comm.*, 62 TC 377 (1974), aff'd 76-2 USTC ¶9736 (7th Cir. 1976).
11. *Auerbach v. Comm.*, TC Memo 1975-219.
12. *Mandel v. Comm.*, 229 F.2d 382 (7th Cir. 1956).

Estate Tax Issues

105. If life insurance proceeds are required under the terms of a property settlement agreement or a divorce decree to be paid to certain beneficiaries, are the proceeds includable in the insured's estate?

Includability of Proceeds or Premiums

The IRS has ruled that where a divorced wife had an absolute right, under terms of a property settlement agreement incorporated by reference in a divorce decree, to annuity payments after the death of her former husband, and such payments were to be provided by insurance on his life maintained by him for that purpose, the former husband possessed no incidents of ownership in the insurance at his death. As a result, no part of the insurance proceeds was includable in his estate.[1] (See Q 76 for the general rules of includability.) Also, the Tax Court has held that where a divorced husband was required under a property settlement agreement to maintain insurance on his life payable to his former wife, if living, but otherwise to their surviving descendants or to his former wife's estate if there were no surviving descendants, the insured possessed no incidents of ownership in the insurance. The insurance, in other words, was not merely security for other obligations.[2] In another case, the Tax Court held that where an insured was subject to a court order requiring the insured to maintain insurance on his life payable to his minor children, such court order, operating in conjunction with other applicable state law, effectively nullified incidents of ownership the insured would otherwise possess by policy terms.[3]

When, on the other hand, the divorced husband was merely required to maintain a stated sum of insurance on his life payable to his former wife so long as she lived and remained unmarried, the insured was held to have retained a reversionary interest sufficient in value to make the proceeds includable in his estate (Q 81).[4] It also has been held that where, pursuant to a divorce decree, the proceeds of insurance maintained by a divorced husband on his own life to secure alimony payments are paid following the insured's death directly to the former wife, the proceeds are includable in the insured's estate. The Board of Tax Appeals reasoned that because the proceeds satisfy a debt of the decedent or his estate, the result is the same as if the proceeds are received by the decedent's executor (Q 76).[5]

106. When life insurance proceeds are required under the terms of a property settlement agreement or a divorce decree to be paid to certain beneficiaries, is an offsetting deduction allowable?

Where insurance proceeds payable to a divorced spouse are required to be included in the insured's estate, it is sometimes possible to secure an offsetting deduction either (1) on the basis that the beneficiary's right to the proceeds amounts to a claim against the estate representing

1. Rev. Rul. 54-29, 1954-1 CB 186.
2. *Est. of Bowers v. Comm.*, 23 TC 911 (1955), acq. 1955-2 CB 4.
3. *Est. of Beauregard v. Comm.*, 74 TC 603 (1980), acq. 1981-1 CB 1.
4. Rev. Rul. 76-113, 1976-1 CB 276.
5. *Est. of Mason v. Comm.*, 43 BTA 813 (1941), nonacq. 1941-1 CB 17 (1941).

a personal obligation of the decedent existing at the time of death[1] or (2) on the basis that the beneficiary's interest in the proceeds amounts to an indebtedness against the proceeds included in the estate.[2]

A deduction is not allowed on either basis, however, if the claim or indebtedness is founded on an agreement between the spouses in the nature of a property settlement agreement not supported by "adequate and full consideration in money or money's worth."[3] Where (i) property is transferred from a decedent or from a decedent's estate to a former spouse of the decedent pursuant to a property settlement agreement, (ii) divorce occurred within a three-year period measured from the date one year before the agreement was entered into, and (iii) the property is includable in the decedent's gross estate, the transfer is considered to be made for an adequate and full consideration in money or money's worth.[4] A relinquishment or promised relinquishment of marital rights in property is not consideration in money or money's worth.[5] Although one court held that a wife's right to support is a "marital right in property,"[6] the IRS has declined to follow the decision[7] and declares instead that a release of support rights by a spouse constitutes consideration in money or money's worth.[8] The Tax Court has consistently agreed that a spouse's relinquishment or promised relinquishment in a separation agreement of support rights is consideration in money or money's worth.[9]

Even though it is found that the relinquishment or promised relinquishment of support rights is consideration in money or money's worth, it also must be found that the claim or indebtedness against property was "contracted bona fide and for an adequate and full consideration in money or money's worth."[10] It must be found, in other words, that that which is sought to be deducted from the estate was bargained for in exchange for support rights. Thus, the executor of the estate must be prepared to show, according to applicable local law, the value of the support rights at the time the separation agreement was entered into. If the executor is unable to establish a dollar value by any reasonable approach, such as taking into account the value of the marital assets and the former spouses' incomes and their expenses, the deduction sought will be denied.[11] If a dollar value of the support rights is established, the deduction allowed cannot exceed that amount or, if less, the amount of the claim.

If insurance proceeds are payable to a former spouse pursuant to the terms of a property settlement agreement (but not pursuant to a court decree), the insured's estate may be permitted an offsetting deduction to the extent of the value of any support rights relinquished by the

1. IRC Sec. 2053(a)(3).
2. IRC Sec. 2053(a)(4).
3. IRC Sec. 2053(c)(1)(A).
4. IRC Sec. 2043(b)(2).
5. IRC Secs. 2053(e), 2043(b).
6. *Meyer's Est. v. Helvering*, 110 F.2d 367 (2nd Cir. 1940), cert. den. 310 U.S. 651.
7. Rev. Rul. 68-379, 1968-2 CB 414.
8. Rev. Rul. 71-67, 1971-1 CB 271; Rev. Rul. 75-395, 1975-2 CB 370.
9. *McKeon v. Comm.*, 25 TC 697 (1956); *Est. of Glen v. Comm.*, 45 TC 323 (1966); *Est. of Iverson v. Comm.*, 65 TC 391 (1975), rev'd and remanded on another issue, 552 F.2d 977 (3rd Cir. 1977); *Est. of Satz v. Comm.*, 78 TC 1172 (1982). See also *Bowes v. U.S.*, 77-2 USTC ¶13,212 (N.D. Ill. 1977).
10. IRC Sec. 2053(c)(1)(A).
11. *Est. of Iverson*, *Est. of Satz*, both cited above.

former spouse under the agreement.[1] But to the extent the proceeds exceed the value of such support rights, no deduction is allowable if the only other consideration given by the former spouse was relinquishment or promised relinquishment of inheritance rights in the decedent's property. For information on how to value support rights, see Revenue Ruling 71-67[2] and *Est. of Fenton v. Comm.*[3]

When a property settlement agreement is incorporated in a divorce decree, and when the divorce court is free to ignore the allowances made in the agreement and to set different allowances in its own discretion instead, the obligations of the parties are not "founded upon a promise or agreement" but upon the divorce decree. In this case, a deduction of a proper claim or indebtedness under IRC Section 2053 is allowable without regard to the nature of the consideration given by the former spouse.[4] Even if both the agreement and the court decree provide that the covenants in the agreement shall survive any decree of divorce that may be entered, the obligations of the parties are still founded on the court decree, not on a promise or agreement.[5]

On the other hand, where a property settlement agreement is incorporated in a divorce decree, but under applicable state law the divorce court is not free to disregard the provisions of a valid property settlement agreement, the obligations of the parties are held to be founded upon a promise or agreement and not upon the divorce decree. In such case, the availability of the offsetting estate tax deduction is limited as previously explained.[6]

Also, the IRS has ruled that where life insurance proceeds were payable to an insured husband's minor children pursuant to a divorce decree, the deduction was not allowable because (1) the decree exceeded the support obligation imposed by state law in requiring the spouse to maintain insurance on his life payable to his children, and (2) the maintenance of the insurance was not contracted for a full and adequate consideration.[7]

107. Is the deduction under IRC Section 2053(a)(3) considered a claim against the insured's estate?

The IRS has held that the availability of the deduction under IRC Section 2053(a)(3) depends upon the nature of the insured's legal obligation under the divorce decree. If the insured's obligation was simply to keep the policy in full force and effect with all premiums paid as long as the former spouse lived and remained unmarried, and the insured did that, then no obligation survived the insured's death and the insured's estate would not be entitled to a deduction. If, on the other hand, the divorce decree provided for the payment to the

1. *Gray v. U.S.*, 78-1 USTC ¶13,244 (C.D. Cal. 1978), on remand; *Est. of Fenton v. Comm.*, 70 TC 263 (1978).
2. 1971-1 CB 271.
3. 70 TC 263 (1978).
4. *Comm. v. Maresi*, 156 F.2d 929 (2nd Cir. 1946); *Comm. v. Est. of Watson*, 216 F.2d 941 (2nd Cir. 1954), acq. 1958-1 CB 6; *Young v. Comm.* 39 BTA 230 (1939); *Est. of Mason v. Comm.*, 43 BTA 813 (1941).
5. *Harris v. Comm.*, 340 U.S. 106 (1950); *Est. of Robinson v. Comm.*, 63 TC 717 (1975).
6. *Est. of Bowers v. Comm.*, 23 TC 911 (1955), acq. 1955-2 CB 4; *Est. of Barrett v. Comm.*, 56 TC 1312 (1971); *Gray v. U.S.*, 541 F.2d 228 (9th Cir. 1976), reversing and remanding 391 F. Supp. 693; *Est. of Satz v. Comm.*, 78 TC 1172 (1982); Rev. Rul. 60-160, 1960-1 CB 374; Rev. Rul. 75-395, 1975-2 CB 370.
7. Rev. Rul. 78-379, 1978-2 CB 238.

decedent's former spouse of a specific sum of money upon the decedent's death, and the decedent provided the funds by the purchase of life insurance, then the payment of the required amount would be a personal obligation of the decedent, so it would be payable from the decedent's estate if the insurer was unable to meet its obligation. Under these circumstances, any proceeds payable to the former spouse to discharge the decedent's obligation would be deductible under IRC Section 2053(a)(3).[1]

108. Is a deduction under IRC Section 2053(a)(4) considered a debt against the insured's estate?

The Tax Court has allowed an offsetting deduction under IRC Section 2053(a)(4) where a divorced husband was required under the terms of a property settlement agreement incorporated in a divorce decree to maintain a certain amount of insurance on his life payable to his former wife, and where the proceeds were paid upon his death directly from the insurer to the former wife as beneficiary. The court held that the proceeds were property included in the estate and subject to an indebtedness even though, because the proceeds were paid directly to the former wife, it was not necessary for her to file a claim against the estate.[2] The Tax Court also has allowed a deduction under IRC Section 2053(a)(4) where the decedent had been ordered through a divorce decree to assign two policies to the decedent's former spouse.[3]

The position of the IRS now is that when a divorced spouse is required by the terms of a divorce decree to maintain insurance on his or her life payable to his or her former spouse, the estate is allowed an offsetting deduction under IRC Section 2053(a)(4) until the beneficiary spouse dies or remarries.[4] (On these facts, the deduction would not be allowed under IRC Section 2053(a)(3) – see above.) The IRS has ruled similarly when, in a paternity action adjudicating custody and support rights, the insured was required by court decree to maintain insurance on the insured's life for the benefit of the insured's child.[5]

Gifts and Charitable Gifts

109. If a taxpayer gives a spouse a life insurance policy, is the taxpayer entitled to a gift tax marital deduction?

Yes.

An outright gift of a life insurance policy to the donor's spouse qualifies for the gift tax marital deduction on the same basis as the gift of a bond or any other similar property.[6] The same should hold for subsequent premiums paid on the policy by the donor. An annual exclusion may be allowed instead of the marital deduction if the donee spouse is not a U.S. citizen. See Q 152 for gift of policy in trust.

1. Rev. Rul. 76-113, 1976-1 CB 276.
2. *Est. of Robinson v. Comm.*, 63 TC 717 (1975), acq. 1976-2 CB 2.
3. *Est. of DeVos v. Comm.*, TC Memo 1975-216.
4. Rev. Rul. 76-113, 1976-1 CB 276.
5. Let. Rul. 8128005.
6. *Kidd v. Patterson*, 230 F. Supp. 769 (N.D. Ala. 1964).

110. If a primary beneficiary of life insurance proceeds payable under a settlement option has the power to withdraw part of the proceeds, does the beneficiary's failure to exercise the power constitute a taxable gift to contingent beneficiaries?

Where the primary beneficiary has an annual, limited, noncumulative right of withdrawal, the beneficiary has made a gift to contingent beneficiaries when the beneficiary fails to exercise the right. A lapse of the right is subject to gift tax only to the extent that the right to withdraw exceeded the greater of $5,000 or 5 percent of the value of the proceeds at the time of lapse (Q 200).[1]

111. How are split-dollar life insurance arrangements treated for gift tax purposes?

Gifts may arise in a split-dollar arrangement when a donor provides a benefit to a donee. For example, an employee or shareholder who irrevocably assigns his or her interest in a compensatory or shareholder split-dollar arrangement (Q 3898) to a third party (such as a family member) may make gifts to such third party (including annual gifts of the amount the employee or shareholder is required to include in income). Also, a donor may make gifts to an irrevocable life insurance trust under a private split-dollar arrangement.

The treatment of split-dollar arrangements may differ depending on whether the arrangement was entered into or modified after September 17, 2003.

Post-September 17, 2003, Arrangements

Regulations generally provide that the treatment of a split-dollar arrangement depends on whether the donor is the owner of the life insurance contract.[2] Even if the donee is named as the policy owner, the donor may be treated as the owner if the only economic benefit provided to the donee is the value of current life insurance protection.

If a life insurance trust is the owner of the policy, the donor makes premium payments, and the donor is entitled to recover an amount equal to the premiums, the donor is treated as making a loan to the trust in the amount of the premium payment. If the loan is repayable on the death of the donor, the term of the loan is equal to the donor's life expectancy on the date of the payment (under Treasury Regulation Section 1.72-9 (see Table V in Appendix A)). The value of the gift equals the premium payment less the present value (determined under IRC Section 7282) of the donor's right to receive repayment. If there is no right to repayment, the value of the gift equals the premium payment.

If the donor is treated as the owner of the policy, the donor is treated as making a gift to the trust. The value of the gift equals the economic benefits provided to the trust, less the amount of premium paid by the trustee. If the donor's estate is entitled to receive the greater of (1) the aggregate premiums paid by the donor or (2) the cash surrender value, the gift is equal

1. IRC Sec. 2514(e).
2. TD 9092, 2003-46 IRB 1055; Treas. Regs. §§1.61-22, 1.7872-15.

to the cost of life insurance protection less premiums paid by the trustee. If the donor's estate is entitled to receive the lesser of (1) the aggregate premiums paid by the donor or (2) the cash surrender value, the gift is equal to the cost of life insurance protection, plus the amount of cash surrender value to which the trust has current access (except to the extent taken into account in an earlier year) and any other economic benefit provided to the trust (except to the extent taken into account in an earlier year), less premiums paid by the trustee. If the donor is treated as the owner of the policy, amounts received by the life insurance trust under the contract (e.g., dividends or policy loan) are treated as gifts from the donor to the trust.

No matter who is treated as the owner of the life insurance policy, there may be a gift upon transfer of an interest in a policy to a third party. See Revenue Ruling 81-198, below.

Pre-September 18, 2003, Arrangements

In a 1978 ruling, a wife owned a policy on the split-dollar plan on the life of her husband. The husband's employer paid the portion of the premiums equal to annual cash value increases and was entitled to reimbursement from death proceeds. The IRS ruled that the value of the life insurance protection provided by the employer, which the IRS also ruled was included in the husband's income (Q 3898), was deemed to be a gift from the husband to the wife, subject to the gift tax.[1]

In Revenue Ruling 81-198,[2] an employee made a gift of his rights under a basic plan of split-dollar insurance (as described in Q 3898) in which the insurance was premium paying and was in force for some time. The IRS ruled that three elements are valued. First, the value of the insured's rights in the policy at the date of the gift is the interpolated terminal reserve plus the proportionate part of the last premium paid before the date of the gift covering the period beyond that date, reduced by the total of premiums paid by the employer. Second, the premiums paid by the insured following the date of the gift are gifts on the date paid. Third, the value of the life insurance protection provided by the employer, included in the employee's gross income, is deemed to be a gift by the employee.

A letter ruling dated December 4, 1972, provided that a gift of the amount at risk under a split-dollar plan is valued as the greater of (1) the value of the insurance protection as computed for income tax purposes (Q 3899) or (2) the difference between the premium payment and the increase in the cash surrender value of the policy. A later technical advice memorandum stated that, with respect to a split-dollar plan, a gift may be made of (1) the value of the insurance protection and (2) increases in cash surrender values in excess of premiums paid by, and returnable to, the corporation.[3]

1. Rev. Rul. 78-420, 1978-2 CB 67, revoked by Rev. Rul. 2003-105, 2003-40 IRB 696, for split-dollar arrangements entered into or modified after September 17, 2003.
2. 1981-2 CB 188.
3. TAM 9604001.

112. What is the advantage of the "split-gift" law where either a husband or wife gives a life insurance, endowment, or annuity contract to a third person?

If the gift qualifies as a present interest gift (Q 213), each spouse's annual exclusion ($14,000 in 2013 and 2014, up from $13,000 in 2012, see Appendix D) can be applied to reduce or eliminate the gift tax. Thus, $28,000 (in 2014, 2 × $14,000) can be subtracted from the value of the contract given and from premiums paid by the donor as gifts in subsequent years (so long as the spouse consents each year) in computing taxable gifts for years in which the gifts are made. The consenting spouse's unified credit also can be applied against any gift tax imposed on the spouse's gift where the gift is in excess of the allowable exclusion or is a future interest gift. (See also Q 209.)

113. Does an employee covered under a survivor income benefit plan make a gift of the survivor benefit for federal gift tax purposes?

No.

Under a survivor income benefit plan, an employer provides an income benefit for certain survivors designated by family or marital relationship to the employee. An employee does not make a gift of the survivor benefit at the time of death.[1] Note that neither Revenue Ruling 81-31 nor *Est. of DiMarco v. Comm*. addressed whether an employee should be treated each year as (1) receiving compensation equal to the value of providing a death benefit or survivor income benefit to an eligible survivor if the employee died during the year, and (2) transferring such value to the eligible survivor. The use of the annual exclusion and the marital deduction might protect such a gift from any gift tax. (See Q 95 for estate tax aspects and Q 243 for income tax aspects.)

114. How are life insurance policies and endowment contracts valued for gift tax purposes?

Generally, the value of a gift of life insurance is established through the sale by the company of comparable contracts.[2]

If a new policy is purchased for another, or is transferred as a gift immediately after purchase, its gift value is the gross premium paid by the donor to the insurance company.[3]

If a person makes a gift of a previously purchased policy, and the policy is single-premium or paid-up, its gift value is the single premium that the company would charge currently for a comparable contract of equal face value on the life of a person who is the insured's age at the time of the gift.[4] A 1978 ruling concerned a single premium life policy in force for 20 years

1. Rev. Rul. 92-68, 1992-2 CB 257, revoking Rev. Rul. 81-31, 1981-1 CB 475 (in which the Service treated an employee as making a gift of the benefit from a death-benefit-only plan in the year of the employee's death); *Est. of DiMarco v. Comm.*, 87 TC 653 (1986), acq. in result, 1990-2 CB 1.
2. Treas. Reg. §25.2512-6.
3. Treas. Reg. §25.2512-6(a), Example 1.
4. Treas. Reg. §25.2512-6(a), Example 3.

where the replacement cost of a single premium life policy of the same face value on the same insured was substantially less than the cash surrender value of the existing policy. The IRS ruled that the replacement contract would not be "comparable" and that in the absence of information pertaining to a "comparable contract" the value of the policy would be determined by reference to the interpolated terminal reserve value (see below).[1]

If the gift is of a policy on which further premiums are payable, the value is established by adding the "interpolated terminal reserve" (the reserve adjusted to the date of the gift) and the value of the unearned portion of the last premium.[2]

Example. A gift is made four months after the last premium due date of an ordinary life insurance policy issued nine years and four months before the gift was made by the insured, who was thirty-five years of age at date of issue. The gross annual premium is $2,811. The computation is as follows:

Terminal reserve at end of tenth year	$14,601.00
Terminal reserve at end of ninth year	$12,965.00
Increase	$1,636.00
One-third of such increase (the gift having been made four months following the last preceding premium due date) is	$545.33
Terminal reserve at end of ninth year	$12,965.00
Interpolated terminal reserve at date of gift	$13,510.33
Two-thirds of gross premium ($2,811)	$1,874.00
Value of gift	$15,384.33

The amount of a policy loan outstanding at the time of the gift would be subtracted.[3]

The effect of the circumstance that the insured is uninsurable at the time of the gift is uncertain; there is no case directly on point.[4]

See Q 111 regarding gifts with respect to split-dollar arrangements.

If the gift of the policy or contract is conditioned upon payment of the gift tax by the donee, the value of the gift is reduced by the amount of the gift tax paid by the donee.[5]

A group term life policy assigned by an employee to an irrevocable trust on the day before a monthly premium was due was held to have no ascertainable value for gift tax purposes, but it was also held that after the assignment the employee would be deemed to have made a gift to the assignee whenever the employer paid a premium.[6] A 1984 revenue ruling valued the gift as follows: If the plan of group term insurance is nondiscriminatory or the employee is not a key employee, the Table I rates may be used. If the employee chooses not to use Table I,

1. Rev. Rul. 78-137, 1978-1 CB 280.
2. Treas. Reg. §25.2512-6(a), Example 4.
3. IRS Form 712, Part II.
4. See *U.S. v. Ryerson*, 312 U.S. 260 (1941); 54 Harvard L. Rev. 895 (1941); *Est. of Pritchard v. Comm.*, 4 TC 204 (1944); Treas. Reg. §25.2512-1.
5. Rev. Rul. 75-72, 1975-1 CB 310. See also Rev. Rul. 76-104, 76-1 CB 301; Rev. Rul. 76-105, 76-1 CB 304.
6. Rev. Rul. 76-490, 1976-2 CB 300.

or if the plan is discriminatory and the employee is a key employee, the employee should use the actual cost allocable to the employee's insurance by obtaining the necessary information from the employer. The rates apply to the full face amount of the insurance.[1] Projecting the holding of the 1984 ruling to the nondiscrimination rules applicable to taxable years ending after October 22, 1986 (Q 232), it would seem that if the plan of group term insurance is discriminatory with respect to the employee, the employee must use the higher of Table I rates or actual cost.

115. May a charitable contribution deduction be taken for the gift of a life insurance policy or premium? May a charitable contribution deduction be taken for the gift of a maturing annuity or endowment contract?

Yes, subject to the limits on deductions for gifts to charities.

The amount of any charitable contribution must be reduced by the amount of gain that would have represented ordinary income to the donor had the donor sold the property at its fair market value.[2] Gain realized from the sale of a life insurance contract is taxed to the seller as ordinary income (Q 36). Therefore, the deduction for a gift of a life insurance policy to a charity is restricted to the donor's cost basis in the contract when the value of the contract exceeds the premium payments. Thus, if a policy owner assigns the policy itself to a qualified charity, or to a trustee with a charity as irrevocable beneficiary, the amount deductible as a charitable contribution is either the value of the policy or the policy owner's cost basis, whichever is less (Q 139).[3] It is not necessary, however, to reduce the amount of the contribution when, by reason of the transfer, ordinary income is recognized by the donor in the same taxable year in which the contribution is made.[4] Letter Ruling 9110016, which denied a charitable deduction when a policy was assigned to a charity that had no insurable interest under state law, was revoked after the taxpayer decided not to proceed with the transaction.[5]

Premium payments also are deductible charitable contributions if a charitable organization or a trustee of an irrevocable charitable trust owns the policy.[6] It is not settled whether premium payments made by the donor to the *insurer* to maintain a policy given to the charity, instead of making cash payments directly to the *charity* in the amount of the premiums, are gifts *to* the charity or merely gifts *for the use* of the charity. The difference is important when the donor wishes to take a charitable deduction of more than 30 percent of the donor's adjusted gross income. When the policy is merely assigned to a charitable organization as security for a note, the premiums are not deductible even though the note is equal to the face value of the policy and is payable from the proceeds at either the insured's death or the maturity of the policy. The reason is that the note could be paid off and the policy recovered after the insured has obtained charitable deductions for the premium payments. A corporation, as well as an individual, can

1. Rev. Rul. 84-147, 1984-2 CB 201.
2. IRC Sec. 170(e)(1)(A).
3. See *Behrend v. Comm.*, 23 BTA 1037 (1931), *acq.* X-2 CB 5; *Tuttle v. U.S.*, 305 F. Supp. 484 (1969).
4. Treas. Reg. §1.170A-4(a).
5. Let. Rul. 9147040.
6. *Hunton v. Comm.*, 1 TC 821 (1943); *Behrend v. Comm.*, 23 BTA 1037 (1931); Let. Ruls. 8708083, 8304068.

take a charitable contribution deduction for payment of premiums on a policy that has been assigned to a charitable organization.[1]

Planning Point: For a number of reasons, including concerns over the rules limiting a tax deduction to the lesser of fair market value or basis and because of the uncertainty regarding tax consequences of premium payments made by the donor directly to the insurance company on a policy owned by a charity, it is generally preferable for a donor to make cash gifts to a charity and allow the charity to pay premiums on policies owned by the charity. It is important, however, not to require that the cash gifts be used for premium payments.

116. May a charitable contribution deduction be taken for a gift of an interest in a split-dollar arrangement?

No deduction is allowed for a transfer to a charitable organization made after February 8, 1999, if in connection with the transfer the charitable organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract" with respect to the transferor. Further, no deduction is allowed if there is an understanding or expectation that any person will directly or indirectly pay any premium on a personal benefit contract with respect to the transferor.[2] A personal benefit contract is any life insurance, annuity, or endowment contract if a direct or indirect beneficiary under the contract is the transferor, a member of the transferor's family, or any other person (other than certain charitable organizations) designated by the transferor.[3]

In a case decided under rules in effect before 1999, a charitable deduction was not allowed where the charity provided a receipt stating that the donors received no benefit from their charitable contribution. The court held that in fact the donors were receiving a benefit under the charitable split-dollar arrangement.[4]

In a ruling involving a paid-up policy, the IRS took the position that no deduction will be allowed for gifts made after July 31, 1969, involving a split-dollar plan in which the donor gives a charity the cash surrender value and gives a noncharitable beneficiary the balance. A gift of the cash surrender value is considered a gift of less than an entire interest in the property whether the donor retains the right to designate the beneficiary of the risk portion or irrevocably designates the beneficiary prior to making the gift.[5] Two 1969 revenue rulings, which allow a deduction, apply only to gifts made on or before July 31, 1969.[6]

117. Are there any exceptions to the disallowance rule for transfers of charitable gift annuity contracts?

There are exceptions to the disallowance rule for certain transfers involving charitable gift annuity contracts (Q 530) and charitable remainder trusts.[7]

1. Rev. Rul. 58-372, 1958-2 CB 99.
2. IRC Sec. 170(f)(10)(A).
3. IRC Sec. 170(f)(10)(B).
4. *Addis v. Comm.*, 2004-2 USTC ¶50,291 (9th Cir. 2004).
5. Rev. Rul. 76-143, 1976-1 CB 63.
6. Rev. Rul. 69-79, 1969-1 CB 63; Rev. Rul. 69-215, 1969-1 CB 63.
7. IRC Secs. 170(f)(10)(D), 170(f)(10)(E).

118. Are there any penalties that can be imposed upon a charitable institution in connection with a gift of life insurance where a deduction is not allowable?

A charitable organization that pays premiums after December 17, 1999, on a life insurance, annuity, or endowment contract in connection with a transfer for which a charitable deduction was not allowable is subject to a penalty tax equal to the amount of premiums paid.[1] The IRS has indicated that other penalties may be imposed on charitable organizations involved in charitable split-dollar plans.[2]

119. May a charitable contribution deduction be taken for a gift of a life insurance policy if the donor retains a right, shared with the donee charity, to change charitable beneficiaries?

While the Internal Revenue Code (IRC) generally disallows a charitable deduction for gifts of less than the donor's entire interest in property, it does permit limited exceptions to this rule. One of these is a gift of an "undivided interest" in property. This means that the donor may give less than his entire interest and still take a charitable gift deduction if he gives "a fraction or percentage of each and every substantial interest or right" he owns in the property.[3]

In a letter ruling, the IRS took the position that a gift of a life insurance policy to a charity was deductible even though the donor retained the right, exercisable in conjunction with the donee charity, to change the charitable beneficiaries. The IRS reasoned that by sharing the right to change charitable beneficiaries, the donor had given an undivided interest in the right he retained and thus the gift came within the exception to the rule against deducting partial interest gifts.[4]

120. May a charitable contribution deduction be taken for a gift of the annuity portion of a split-life contract?

The IRS has ruled that a gift to charity of the annuity portion of a split-life contract is not deductible because it is a gift of less than the donor's entire interest in property.[5] The IRS reasoned that the donor, prior to making the gift, exercised the right to purchase the annual term insurance and, thus, the donor had retained a right in the property. Furthermore, the donor's subsequent annual cash contributions equal to the annuity premiums were treated by the IRS as given in exchange for the charity's continued election to allow the donor to renew the term life insurance. Thus, the donor continued to retain the right to purchase the annual term insurance. Because the donor retained a right, the donor's gift of the annuity portion was of less than the donor's entire interest in the property.[6] The ruling did not clearly deal with the deduction of the annual cash contributions and some commentators believe they might be deductible.

1. IRC Sec. 170(f)(10)(F).
2. Notice 99-36, 1999-2 CB 1284.
3. IRC Sec. 170(f)(3)(B)(ii); Treas. Reg. §1.170A-7(b)(1)(i).
4. Let. Rul. 8030043.
5. See IRC Sec. 170(f)(3).
6. Rev. Rul. 76-1, 1976-1 CB 57.

However, the reasoning of the IRS – that the annual contributions were in exchange for the continued right to renew the term insurance – suggests that the donor's entire interest in the cash contributions was not given.

121. If life insurance proceeds are payable to a religious, charitable, or educational organization, is their value taxable in the insured's gross estate?

Generally, no. If the insured has any incident of ownership in the policy at the time of death, the proceeds are includable in the insured's gross estate, but a charitable deduction is allowable for their full value.[1]

If, however, the law in the state of the donor's domicile does not recognize that a charity has an insurable interest in the life of the donor, complications may arise. In some states, a charity may not have an insurable interest with respect to a newly issued insurance policy given to the charity or for a policy applied for and issued to the charity as owner and beneficiary. If the charity does not have an insurable interest and the insurer or the insured's estate raises the question of lack of an insurable interest, the insured's estate may be able to recover the proceeds (or the premiums paid). The proceeds are includable in the insured's estate to the extent that the proceeds could be received by the insured's estate. No charitable deduction may be allowed if the executor recovers the proceeds for the estate or if the executor were to fail to recover the proceeds and the proceeds passed to charity.[2]

122. Are gifts of life insurance to charitable organizations subject to gift tax?

Generally, no. An individual may take a gift tax deduction for the full value of gifts to qualified charities of life insurance and annuity contracts, and of premiums or consideration paid for such contracts owned by qualified charities.[3] Such a deduction is not allowed where an insured assigns (even irrevocably) to a charity the cash surrender value of a life insurance policy (either paid-up or premium paying), including a right to death proceeds equal to the cash surrender value immediately before death, if the donor retains the right to name or change the beneficiary of proceeds in excess of the cash surrender value and to assign the balance of the policy subject to the charity's right to the cash surrender value. According to the IRS, such a gift is neither one of the donor's entire interest in the property nor one of an undivided portion of the donor's entire interest in the property (Q 116), and so the deduction is disallowed under IRC Section 2522(c).[4]

If the law in the state of the donor's domicile does not recognize that a charity has an insurable interest in the life of the donor, a charitable deduction may not be allowed for a gift of a newly

1. IRC Secs. 2042(2), 2055; *McKelvy v. Comm.*, 82 F.2d 395 (3rd Cir. 1936); *Comm. v. Pupin*, 107 F.2d 745 (2nd Cir. 1939).
2. See Let. Rul. 9110016 (revoked by Let. Rul. 9147040 when state law was amended to permit an insured to immediately transfer a newly purchased life insurance policy to charity).
3. IRC Sec. 2522.
4. Rev. Rul. 76-200, 76-1 CB 308.

issued insurance policy (or premiums paid on the policy) or for gifts of premium payments on a policy applied for and issued to the charity as owner and beneficiary.[1]

Single Premium Whole Life Insurance Policy

123. How are single premium life insurance policies, including single premium variable life insurance policies, taxed?

A single premium life insurance policy generally is treated in the same manner as a multiple-premium life insurance policy for income tax purposes. For all life insurance policies that meet the definition of life insurance (Q 64), cash surrender value increases generally are not taxed until received (Q 8) and death proceeds generally are received income tax-free (Q 62).

The tax treatment of policy loans depends on whether the policy is treated as a modified endowment contract (MEC). Most single premium policies are considered MECs; policies entered into on or after June 21, 1988, that do not meet the seven pay test of IRC Section 7702A(b) are classified as MECs. Loans from MECs are taxable as income at the time received to the extent that the cash value of the contract immediately before the payment exceeds the investment in the contract.[2] These distributions also may be subject to a penalty tax of 10 percent (Q 13).[3]

Life insurance policies, including single premium policies, issued prior to June 21, 1988, generally are grandfathered and are not subject to the seven pay test. Loans from these policies will not be treated as taxable income. Loans from policies that are not grandfathered but that meet the requirements of the seven pay test also are not treated as taxable income. Any outstanding loan becomes taxable income at the time of policy surrender or lapse, however, to the extent that the loan exceeds the owner's basis in the contract (Q 10). If policy death proceeds are tax-free, the amount of the loan is not taxed but is treated as part of the tax-free death proceeds (Q 64). Note that a grandfathered policy may lose its grandfathered status if it undergoes a material change in its terms or benefits or is exchanged for another life insurance policy under IRC Section 1035 (Q 13).

Creditor Insurance

124. If a debtor pays premiums on a life insurance policy on his or her life in favor of his or her creditor, may the debtor take an income tax deduction for these premium payments?

No.

The answer is the same regardless of whether the debtor takes out a new policy for the benefit of the creditor or assigns an existing policy to the creditor. The deduction will be denied even though the debtor was required to take out the policy to obtain the loan. If the debt is

1. See Let. Rul. 9110016 (revoked by Let. Rul. 9147040 when state law was amended to permit an insured to immediately transfer a newly purchased life insurance policy to charity).
2. IRC Sec. 72(e).
3. IRC Sec. 72(v).

personal, the premiums are nondeductible personal expenses.[1] If the debt is a business debt, the deduction is denied under IRC Section 264(a)(1), which provides that no deduction is allowed for premiums on any life insurance policy, endowment, or annuity contract if the taxpayer is directly or indirectly a beneficiary under the policy or contract. For this purpose, the insured debtor is at least indirectly a beneficiary under the policy because the proceeds may be used to satisfy the insured's debt.[2]

IRC Section 264(a)(1) also acts as a bar to a nonbusiness deduction. Thus, the deduction was denied for premiums the taxpayer paid on insurance used as collateral for a bank loan to a company in which the taxpayer was a major stockholder; the premiums were paid to protect the taxpayer's personal securities, which were also part of the collateral for the loan.[3]

The deduction is disallowed even when the person who pays the premiums is merely a guarantor and therefore only secondarily liable for the debt.[4]

125. Can a creditor deduct premiums paid on life insurance purchased on the life of the creditor's debtor?

Based on the reasoning of the cases cited in Q 127, it appears unlikely that the creditor can secure a nonbusiness expense deduction. Moreover, when proceeds are receivable as tax-exempt life insurance proceeds, it would appear that IRC Section 265(a)(1) prohibits that deduction of premiums (Q 261).

If the debtor is directly or indirectly a beneficiary under the policy, IRC Section 264(a)(1) prohibits the deduction (Q 245). The IRS has allowed a business expense deduction for premiums paid by a taxpayer in the business of selling property for one-year term insurance purchased on the lives of installment purchasers where no separate charge was made for the insurance and where the death proceeds (payable to the seller) were in the amount of the unpaid balance of the purchase price. Proceeds receivable by the seller were treated as collections on the purchase price, *not* as life insurance proceeds excludable under IRC Section 101(a).[5]

126. If a creditor pays premiums on a life insurance policy held as collateral for a business debt, can the creditor claim an income tax deduction for the premium payments?

The IRS takes the position that the creditor cannot claim a deduction unless the creditor shows that the creditor's right to reimbursement for the premium payment was worthless in the year of payment. Thus, if the creditor has a right to proceed against the debtor for reimbursement, the debtor must be insolvent or the claim must be otherwise uncollectible. If the creditor has a right, express or implied, to reimbursement from the policy, the cash surrender

1. IRC Sec. 262.
2. *Glassner v. Comm.*, *cert. denied*, 385 U.S. 819 (1966); *O'Donohue v. Comm.*, 33 TC 698 (1960); *Hanson v. Comm.*, TC Memo 1970-15; Rev. Rul. 68-5, 1968-1 CB 99.
3. *Carbine v. Comm.*, 85-2 USTC ¶9854 (11th Cir. 1985).
4. *D'Angelo Assoc., Inc. v. Comm.*, 70 TC 121 (1978), acq. in result, 1979-1 CB 1.
5. Rev. Rul. 70-254, 1970-1 CB 31.

value must be insufficient to cover the balance of the unpaid debt and the premium payment. If the creditor has both rights, both must be worthless.[1] Premiums that are not deductible are treated as additional advances that increase the debt.

Courts, however, have allowed the deduction without regard to the taxpayer's ability to recover the premium out of the cash surrender value of the policies.[2]

The IRS would disallow a deduction for the premium payment if the creditor has taken a bad debt deduction for the debt and the cash surrender value of the policy is sufficient to provide reimbursement for the premium payment. In *Charleston Nat'l Bank*, however, the court held that the premium payment was deductible even though the creditor had taken a bad debt deduction for the debt and the cash surrender value exceeded the current premium and premium payments not deducted in prior years.

The deduction is allowable not as a bad debt but as an ordinary and necessary business expense, incident to the protection of the collateral.[3]

If premiums that have been deducted are later recovered from the proceeds, the recovery must be reported as taxable income. If the premiums have not been deducted, however, the recovery will be tax-free.[4]

127. If a creditor pays premiums on a life insurance policy securing a non-business debt, can the creditor deduct the premium payments?

The deduction has been denied on the ground that the premium payments are a capital investment rather than expenses incurred "for the production or collection of income, or for the management, conservation and maintenance of property held for the production of income."[5]

128. If a stockholder's personal life insurance is used as collateral security for the corporation's debt, are the premiums deductible?

If the insured stockholder pays the premiums, the stockholder is denied a deduction on the ground that the premium payments are not an ordinary and necessary expense of carrying on the stockholder's business.[6] If the corporation pays the premiums, they are non-deductible under IRC Section 264(a)(1) because the corporation is indirectly a beneficiary under the policy.[7]

1. Rev. Rul. 75-46, 1975-1 CB 55.
2. *Comm. v. Charleston Nat'l Bank*, 20 TC 253 (1953) *aff'd*, 213 F.2d 45 (4th Cir. 1954); *First Nat'l Bank & Trust Co. v. Jones*, 143 F.2d 652 (10th Cir. 1944).
3. *First Nat'l Bank & Trust Co. v. Jones*, supra; *Blumenthal v. Comm.*, TC Memo 1963-269, *aff'd*, 14 AFTR 2d 5094 (4th Cir. 1964). See also Rev. Rul. 75-46, above.
4. *St. Louis Refrigerating & Cold Storage Co. v. U.S.*, 162 F.2d 394 (8th Cir. 1947).
5. *U.S. v. Mellinger*, 228 F.2d 688 (5th Cir. 1956); *Home News Publishing Co. v. Comm.*, TC Memo 1969-167; see also *Blumenthal v. Comm.*, TC Memo 1963-269, *aff'd*, 14 AFTR 2d 5094 (4th Cir. 1964).
6. *Morison v. Comm.*, TC Memo 1960-243.
7. See Rev. Rul. 68-5, 1968-1 CB 99.

Bad Debt Deduction

129. May a creditor take a bad debt deduction for a worthless debt even though the creditor holds an insurance policy on the life of the debtor as collateral?

Yes, provided the cash surrender value of the policy is less than the debt. The creditor may deduct the difference between the cash surrender value and the debt or, if the policy has no cash surrender value, the creditor may deduct the full amount of the worthless debt. The creditor may take the deduction even though the creditor continues to hold the policy and the face of the policy exceeds the debt. Collateral need not be liquidated to establish the worthless portion of the debt.[1] If a deduction was not previously taken, a deduction for the uncollectible balance may be taken in the year the creditor surrenders the policy.[2] No bad debt deduction will be allowed at any time, however, for advances that were made when prior loans exceeded the face of the policy and the debtor was insolvent.[3]

Proceeds

130. Are proceeds received by a creditor from insurance purchased on the life of the creditor's debtor exempt from income tax as life insurance proceeds?

If a creditor has an insurable interest other than as creditor (e.g., the debtor also is a key person) and has the unconditional right to retain proceeds unaffected by the size of the debt, the proceeds are received tax-free.[4]

In some states, a creditor's insurable interest in the creditor's debtor is limited to indemnification of the amount of the debt (plus premiums the creditor has paid) as of the insured's death. The creditor must hold any excess for the debtor's estate. Where this is so it would appear, based on the reasoning of Rev. Rul. 70-254 and the *Landfield* case (Q 131), that the proceeds would not be considered to have been paid by reason of the insured's death, and therefore would not be exempt as life insurance proceeds under IRC Section 101(a).

Courts in other states, however, have held that where (i) the creditor initiates the purchase of insurance and pays the premiums, (ii) the amount of the insurance is reasonably proportionate to the amount of the debt, and (iii) the debtor consents to the insurance, the creditor's insurable interest, or right of recovery, goes to the full proceeds, not just to the amount of debt, expenses, and interest. Thus, even if the debtor has paid the debt before his or her death, the creditor is entitled to the full proceeds. Under this view, it would appear that the proceeds would be received "by reason of the death of the insured" and therefore should be entitled to the exemption of IRC Section 101(a). If the proceeds are receivable as tax-exempt life insurance proceeds, it would appear that deduction of the premiums would

1. *Hatboro Nat'l Bank v. Comm.*, 24 TC 786 (1955).
2. *Mattlage v. Comm.*, 3 BTA 242 (1925).
3. *Blumenthal v. Comm.*, TC Memo 1963-269, *aff'd*, 14 AFTR 2d 5094 (4th Cir. 1964).
4. *Thomsen & Sons, Inc. v. U.S.*, 73-2 USTC ¶9637 (7th Cir. 1973); *Harrison v. Comm.*, 59 TC 578 (1973), acq. 1973-2 CB 2.

be denied by reason of IRC Section 265(a)(1), which provides that expenses incurred for acquiring tax-exempt income are not deductible.

131. Are life insurance proceeds received by a creditor as collateral assignee or beneficiary "as interest appears" exempt from income tax?

If a creditor is collateral assignee, the creditor receives the proceeds as a recovery on the collateral and not as life insurance proceeds.[1] Consequently, if the creditor has not taken a bad debt deduction, the proceeds are received tax-free as a return of capital. They are tax-free, that is, to the extent of the unpaid debt and any premiums the creditor has paid but not deducted (Q 127, Q 128). If the creditor, however, has received the tax benefit of a bad debt deduction, the proceeds must be reported as taxable income (except to the extent they represent a recovery of premium payments for which no deduction has been taken). If a portion of the proceeds represents interest on the debt, that portion is taxed as ordinary income to the creditor.[2]

If the creditor is named beneficiary as the creditor's "interest might appear" on a policy owned by the debtor, the creditor receives the proceeds as payment of the debt and not as life insurance proceeds. Because the creditor must prove the debt to collect the proceeds, the proceeds are received because of the insured's indebtedness rather than "by reason of the death of the insured," and hence are not exempt under IRC Section 101(a). The proceeds, therefore, constitute taxable income to the creditor to the same extent that direct repayment of the loan would have resulted in income. This is so regardless of whether the debtor or the creditor has paid the premiums.[3]

A different situation arises if the creditor takes title to the insurance policy and releases the debtor from further obligation. Under these circumstances, the proceeds are received as life insurance proceeds, but a transfer for value has taken place (Q 264). As a result, the proceeds are taxable income to the creditor to the extent that they exceed the value of the policy at the time of transfer and premiums and certain other amounts (Q 264) paid after the transfer.[4] There should be no tax liability under the transfer for value rule, however, if the creditor is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or stockholder.[5]

Estate Tax

132. If an insured assigns a life insurance policy as collateral for a loan, are the proceeds includable in the insured's gross estate?

Yes.

This is true regardless of policy ownership or beneficiary designation. To the extent that the creditor has a right to collect the debt from the proceeds, the proceeds are considered to

1. Treas. Reg. §1.101-1(b)(4).
2. *St. Louis Refrigerating & Cold Storage Co. v. U.S.*, 162 F.2d 394 (8th Cir. 1947); *First Nat'l Bank v. Comm.*, TC Memo 1943.
3. *McCamant v. Comm.*, 32 TC 824 (1959); Rev. Rul. 70-254, 1970-1 CB 31.
4. *Federal Nat'l Bank v. Comm.*, 16 TC 54 (1951), nonacq. 1951-2 CB 5 (1951).
5. IRC Sec. 101(a)(2)(B).

be receivable for the benefit of the estate (Q 76).[1] It is immaterial whether the debt is actually paid from estate assets or that the beneficiary has a right to recover from the estate the amount of proceeds paid to the creditor.[2] The amount of the debt outstanding at the date of the insured's death, with interest accrued to that date, is deductible in determining the taxable estate even though the debt is paid from the proceeds.[3] (For a policy loan, see Q 182.)

133. If an insured assigns a life insurance policy in which his or her spouse is the named beneficiary, will the full amount of the proceeds qualify for the marital deduction?

As a general rule, if a property interest passing to a surviving spouse is subject to an encumbrance, only the value of the property interest in excess of the amount of the encumbrance qualifies for the marital deduction.[4] If the debt that is secured by the policy is actually paid from estate assets, or if the spouse-beneficiary has a right of subrogation against the estate and the estate is solvent, the full amount of the proceeds qualifies for the marital deduction despite the collateral assignment.[5] (For a policy loan, see Q 182.)

Government Life Insurance

134. Are proceeds of government life insurance exempt from income tax?

Yes.

The entire amount of the death proceeds is exempt, including the interest element in installment settlements. Likewise, any gain realized on lifetime proceeds from matured endowments or surrender of policies is exempt from income tax. Dividends also are exempt from income tax.[6] The interest on accumulated dividends is not taxable.[7] Accumulated dividends applied to the purchase of additional National Service Life Insurance and the additional paid-up insurance acquired are not subject to federal income tax.[8]

Taxation of Distribution of Life Insurance Contract

135. If a qualified plan trust distributes a life insurance policy to an employee, is the value of the contract taxable to the employee in the year of distribution?

If the contract is a life insurance, retirement income, endowment, or other contract providing life insurance protection, the *fair market value* of the contract at the time of distribution

1. IRC Sec. 2042(1); Treas. Reg. §20.2042-1(b); *Fidelity Trust Co. (Matthews) v. Comm.*, 3 TC 525 (1944); *Est. of Hofferbert v. Comm.*, 46 BTA 1101 (1942); *Morton v. Comm.*, 23 BTA 236 (1931); cf. *Prichard v. U.S.*, 397 F.2d 60 (5th Cir. 1968) and *Bintliff v. U.S.*, 462 F.2d 403 (5th Cir. 1972).
2. *Est. of Gwinn v. Comm.*, 25 TC 31 (1955); *Hornstein (Reinhold) v. Comm.*, 3 TCM (CCH) 285.
3. Treas. Regs. §§20.2042-1(b)(1), 20.2053-4.
4. IRC Sec. 2056(b)(4)(B).
5. *Est. of Gwinn v. Comm.*, 25 TC 31 (1955), acq. 1956-1 CB 4; *Wachovia Bank & Trust Co. v. U.S.*, 163 F. Supp. 832 (Ct. Cl. 1958); Treas. Reg. §20.2056(b)-4(b).
6. 38 U.S.C. §5301(a); Rev. Rul. 71-306, 1971-2 CB 76.
7. Rev. Rul. 91-14, 1991-1 CB 18.
8. Rev. Rul. 72-604, 1972-2 CB 35.

must be included in the distributee's income to the extent that it exceeds the distributee's basis (Q 3847, Q 3864).[1] Inclusion of the contract's fair market value in the distributee's income is not required at the time of distribution, however, to the extent that within sixty days after it is distributed (1) all or any portion of the contract is irrevocably converted to an annuity with no life insurance element, or (2) the contract is treated as a rollover contribution under IRC Section 402(c) (Q 3880).[2]

The fair market value standard also applies if the contract is sold by the plan to a participant or beneficiary. If the fair market value of the contract exceeds the value of the consideration, then such excess (i.e., the "bargain element") is treated as a distribution to the distributee under the plan for all purposes under the IRC. This treatment of the "bargain element" as a distribution applies for transfers occurring after August 28, 2005. For transfers occurring before August 29, 2005, the "bargain element" is includable in the distributee's gross income, but is not treated as a distribution for qualification purposes.[3]

The fair market value standard is effective for distributions or sales occurring after February 12, 2004.[4] Fair market value includes the policy cash value and all other rights under the contract (including any supplemental agreements thereto, whether or not guaranteed).[5] The IRS has issued safe harbor guidance for determining the fair market value of life insurance contracts.[6] Under the safe harbor, fair market value may be the greater of (1) the interpolated terminal reserve and any unearned premiums, plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year, and (2) the product of the "PERC amount" (PERC stands for premiums, earnings, and reasonable charges) and the applicable "Average Surrender Factor." For details on these calculations, see Q 139.

Conversion to annuity contract. If a policy is converted, it then will be subject to the rules for annuity contracts (provided the annuity is nontransferable; see above). The IRS has taken the position that the mere elimination of the element of risk in a retirement income contract when the reserve exceeds the face amount does not convert the insurance contract into an annuity contract. According to the IRS, the insured must act to convert the contract into an annuity contract that has at no time contained an element of life insurance protection.[7] If the policy is distributed in a lump sum distribution, the taxable amount is eligible for favorable capital gains and special averaging treatment to the extent that such rules are still applicable (Q 3862).

Death benefit. When a life insurance contract matures by reason of the insured's death *after* the policy has been distributed from the plan, the proceeds are wholly tax-exempt to the beneficiary.[8]

1. Treas. Reg. §1.402(a)-1(a)(1)(iii).
2. Treas. Reg. §1.402(a)-1(a)(2).
3. See Treas. Reg. §1.402(a)-1(a)(1)(iii).
4. See Rev. Proc. 2005-25, 2005-17 IRB 962.
5. Treas. Reg. §1.402(a)-1(a)(2)(iii).
6. See Rev. Proc. 2005-25, 2005-17 IRB 962.
7. Rev. Rul. 66-322, 1966-2 CB 123.
8. Rev. Rul. 63-76, 1963-1 CB 23.

Collection of Delinquent Income Taxes from Life Insurance

136. Can the federal government reach the cash value of a taxpayer's life insurance for collection of back income taxes?

Yes.

The law is well settled that state exemption laws cannot immunize the cash values of a taxpayer's life insurance from federal tax collection. Moreover, the government can enforce its tax lien despite a gratuitous assignment of the policy with intent to avoid tax collection.[1]

Under a summary levy procedure, the IRS may reach the loan value of a policy subject to a tax lien, but the policy may be kept in force.[2] The insurance company pays over the present loan value of the policy or, if less, the balance of the tax liability. The company also must pay the IRS the amount of any policy loans (other than automatic premium loans) made after the company had notice of the lien. The company is not liable, however, for policy loans made before it had notice of the lien, or for automatic premium loans made after it had notice if the automatic premium loan agreement was entered into before it had notice.[3]

The IRC says the tax levy is satisfied if the insurer pays over "the amount which the person against whom the tax is assessed could have had advanced" to that person by the insurer on the date prescribed by law for the satisfaction of the levy (plus any amounts advanced by the insurer after knowledge of the lien other than under a preexisting automatic premium loan provision in the policy).[4]

The IRS can reach funds in an annuity contract under the same summary levy procedure mentioned above.[5] Further, the IRS also can reach insurance commission payments with a tax lien. For example, where several life insurance agents assigned their commissions to another agent and that agent, in turn, assigned the funds to an irrevocable trust, the IRS was able to reach the commissions to satisfy a tax lien against several of the agents.[6]

137. Can the federal government collect an insured's delinquent income taxes from a beneficiary who receives life insurance death proceeds?

A government tax lien survives an insured's death. Consequently, if a tax lien has attached to the cash surrender value during the insured's life, the taxes can be collected from the proceeds to the extent of the cash surrender value at death. If life insurance proceeds are exempt from the claims of the insured's creditors under applicable *state* law, however, the insured's unpaid taxes cannot be collected from that portion of the proceeds that exceeds the cash surrender

1. *Knox v. Great West Life Assurance Co.*, 212 F.2d 784 (6th Cir. 1954); *U.S. v. Heffron*, 158 F.2d 657 (9th Cir. 1947).
2. IRC Sec. 6321.
3. IRC Sec. 6323(b)(9).
4. IRC Sec. 6332(b).
5. IRC Sec. 6321; see *Prudential Ins. Co. v. Allen*, 98-1 USTC ¶50365 (S.D. Ind. 1998).
6. American Trust v. American Community Mut. Ins. Co., 98-1 USTC ¶50369 (6th Cir. 1998).

value.[1] If the tax assessment was not made until after the insured's death, the beneficiary is not liable for any of the insured's back taxes provided the proceeds are exempt from claims of the insured's creditors under state law.[2]

A different situation exists where the beneficiary is a surviving spouse who has filed joint returns with the insured. When joint returns have been filed, the surviving spouse generally is liable for the back taxes in his or her own right.[3] Thus, the entire proceeds received by a surviving spouse may be subject to a lien for the unpaid taxes.

In one case, in which a wife who was the beneficiary of a policy insuring her husband's life had been indicted but not yet convicted of his murder at the time the IRS served a levy on the policy proceeds, the court found that, under applicable state law, the wife had a property interest in the proceeds and thus the insurance company acted properly in paying the proceeds to the IRS in response to the levy.[4]

In another case, a surviving spouse used the proceeds of a policy insuring the deceased spouse to purchase annuities for the benefit of their children. The court ruled that the IRS was able to reach the funds, in payment of the couple's delinquent income taxes, after the annuity purchase.[5]

In another case, a wife received two death benefit checks from policies insuring her husband's life, placed the checks in a safe deposit box, and then attempted to renounce her interest in the death proceeds under state law after the IRS seized the checks for payment of taxes. A federal district court granted the government's motion for summary judgment, ruling that the wife had accepted the proceeds, and that they were subject to the IRS lien.[6]

Policies Insuring More Than One Life

138. Does the income taxation of a life insurance policy that insures more than one life differ from the taxation of a policy that insures a single life?

Basically, no.

Multiple-life policies may insure two or more lives. Typically, a "first-to-die" or "joint life" policy pays a death benefit at the death of the first insured person to die while a "second-to-die" or "survivorship" policy does not pay a death benefit until the death of the survivor. Estate planning and business continuation planning are two of the more common uses for these types of policies.

Generally, multiple-life policies are subject to the same definition of life insurance applicable to policies insuring a single life. One exception is that for purposes of calculating the net single

1. *U.S. v. Bess*, 357 U.S. 51 (1958).
2. *Comm. v. Stern*, 357 U.S. 39 (1958).
3. IRC Sec. 6013(d)(3).
4. *State Farm v. Howell*, 96-1 USTC ¶50092 (8th Cir. 1996).
5. *Flake v. U.S.*, 95-2 USTC ¶50588 (D. Ariz. 1995).
6. Federated Life Ins. Co. v. Simmons, 97-2 USTC ¶50490 (N.D. Ga. 1997).

premium under IRC Section 7702, multiple-life policies may not take advantage of the three safe harbor tests set forth in proposed regulations for meeting the reasonable mortality charge requirement (Q 64).[1]

For multiple-life policies that meet the definition of life insurance, cash surrender value increases generally are not taxed until received (Q 8) and death proceeds generally are received income tax-free (Q 62). Multiple-life policies are subject to the seven pay test of IRC Section 7702A(b) (Q 13) in the same manner as single life policies. Distributions from life insurance policies entered into before June 21, 1988, or from policies entered into on or after this date that meet the seven pay test, are included in gross income only to the extent they exceed the investment in the contract (Q 10). Policies entered into on or after June 21, 1988 that do not meet the seven pay test become classified as modified endowment contracts. Distributions, including loans, from modified endowment contracts are subject to taxation rules that generally are less favorable than the rules governing the taxation of distributions from life insurance policies that are not modified endowment contracts (Q 13).

In a private letter ruling, the IRS concluded that exchanges involving policies insuring a single life for a policy insuring two lives did not qualify for nonrecognition treatment under IRC Section 1035. The IRS reached this outcome in five similar fact patterns (Q 44).[2]

In another private ruling, however, the IRS approved IRC Section 1035 treatment of the exchange of a joint and last survivor life insurance policy, following the death of one of the insured persons, for a universal variable life insurance policy that insured the survivor (Q 44).[3]

There has been no formal guidance from the IRS as to which rates should be used to measure economic benefit when a multiple-life policy is used in an arrangement that requires the insured or insureds to include the economic benefit of the coverage in income. The most frequently used rates have been those derived from U.S. Life Table 38, which also is used to derive the P.S. 58 rates. P.S. 58 rates generally may not be used in arrangements entered into after January 27, 2002; however, in those situations, Table 2001 may be used. According to the IRS, taxpayers should make appropriate adjustments to the Table 2001 rates if the life insurance protection covers more than one life.[4] When the policy death benefit is payable at the second death, it generally is believed that following the first death, the Table 2001 rates (or P.S. 58 rates, if appropriate) for single lives should be used to measure the survivor's economic benefit. See volume 2, Appendix G for P.S. 58 and Table 2001 rates.

For estate taxation of policies insuring more than one life, see Q 194. For gift taxation of these policies, see Q 206.

1. Prop. Treas. Reg. §1.7702-1(c).
2. Let. Rul. 9542037.
3. Let. Rul. 9248013; see also Let. Rul. 9330040.
4. Notice 2002-8, 2002-1 CB 398.

Value of Unmatured Policy

139. How is the value of a life insurance policy determined for income tax purposes?

Transfers of property after June 30, 1969 in connection with the performance of services are governed by IRC Section 83. For transfers before February 13, 2004, Treasury Regulation Section 1.83-3(e) provided that, "In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property."

For transfers after February 12, 2004, the Treasury Regulations generally treat the policy's fair market value (specifically the policy cash value and all other rights under the contract, including any supplemental agreements to the contract, whether or not they are guaranteed, other than current life insurance protection) as property. For transfers of life insurance contracts that are part of split-dollar arrangements that are *not* subject to the split-dollar regulations (Q 3903), however, only the cash surrender value of the contract is considered property.[1]

The IRS has provided a safe harbor on how to determine the fair market value of a life insurance contract.[2] The fair market value of a life insurance contract may be the greater of either: (1) the interpolated terminal reserve and any unearned premiums, plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year, or (2) the product of the "PERC amount" (PERC stands for premiums, earnings, and reasonable charges) and the applicable "Average Surrender Factor."

The PERC amount for a life insurance contract that is not a variable contract is the aggregate of:

(1) the premiums paid on the policy without a reduction for dividends that offset the premiums, plus

(2) dividends that are applied to purchase paid-up insurance, plus

(3) any other amounts credited or otherwise made available to the policyholder, including interest and similar income items, but not including dividends used to offset premiums and dividends used to purchase paid up insurance, minus

(4) reasonable mortality charges and other reasonable charges, but only if those charges are actually charged and those charges are not expected to be refunded, rebated, or otherwise reversed, minus

(5) any distributions (including dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

1. Treas. Reg. §1.83-3(e).
2. Rev. Proc. 2005-25, 2005-17 IRB 962.

The PERC amount for a variable life contract is the aggregate of:

(1) the premiums paid on the policy without a reduction for dividends that offset the premiums, plus

(2) dividends that are applied to increase the value of the contract, including dividends used to purchase paid-up insurance, plus or minus

(3) all adjustments that reflect the investment return and the market value of the contract's segregated asset accounts, minus

(4) reasonable mortality charges and other reasonable charges, but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed, minus

(5) any distributions (including dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

The Average Surrender Factor is 1.0 when valuing life insurance contracts for purposes of the rules regarding group term life (Section 79), property transferred in connection with the performance of services (Section 83), and certain transfers involving deferred compensation arrangements (Section 402(b)). This is because under these rules no adjustment for potential surrender charges is allowed.

The IRS pointed out that the formulas in its safe harbor rules must be interpreted in a reasonable manner, consistent with the purpose of determining the contract's fair market value. Specifically the rules are not allowed to be interpreted in such a way as to understate a contract's fair market value.

For transfers of property before July 1, 1969, the IRS ruled that the value of an unmatured policy is determined for income tax purposes in the same manner as for gift tax purposes (see Q 114).[1] In one case, the court accepted the value stipulated by the parties in an arm's length agreement.[2]

Demutualization

140. What is the tax treatment when shares of stock received in a demutualization are sold?

A "demutualization" occurs when a mutually-owned life insurance company (i.e., a company owned by its policyholders, or "members") converts into a publicly-owned company (i.e., a company owned by its shareholders). Essentially, the members exchange their rights in the mutual life insurance company (i.e., voting and dividend rights) for shares of stock in the "demutualized" company.

1. Rev. Rul. 59-195, 1959-1 CB 18.
2. *Gravois Planing Mill v. Comm.*, 9 AFTR 2d 733 (8th Cir. 1962).

In one case, a taxpayer (a trust) was a former policyholder in a mutual life insurance company and received shares of stock when that company "demutualized." The taxpayer sold its shares and then reported gain, based on the then-prevalent belief that the "basis" of such stock was zero. The U.S. Court of Federal Claims held that the taxpayer was entitled to a refund of tax paid. The court analyzed the application of the "open transaction doctrine" to the transaction, and then determined that because the amount received by the trustee was less than the trust's cost basis in the policy as a whole, the taxpayer, in fact, did not realize any income on the sale of the shares.[1]

However, in two more recent published opinions, courts reached what appear to be inconsistent decisions on the issue of basis in demutualization stock making the law in this area very unclear. In *Reuben v. US*,[2] the court found that no portion of premiums paid prior to demutualization created basis; therefore the taxpayer had no basis at all in stock received in a demutualization. As a result, all of the proceeds from sale of demutualization stock represented capital gain. This decision appears to be totally inconsistent with the holding in Fisher. But, in *Dorrance v. US*,[3] the court allowed "equitable apportionment" of premiums to determine basis in the demutualization stock. Because of the uncertainty in this area, a taxpayer considering sale of stock received via demutualization should consult his or her tax advisor before completing the sale.

Life Insurance Trusts

141. When will a life insurance trust result in income tax savings for the grantor?

No income tax savings can be achieved by the creation of an unfunded life insurance trust. Additionally, a life insurance policy creates no currently taxable income regardless of whether it is placed in trust. Income tax savings can result only when income-producing property is placed in trust to fund the premium payments, and only if tax liability is shifted from the grantor to a lower bracket taxpayer – that is, to the trust or to a trust beneficiary.

A funded revocable trust will not result in income tax savings. If the trust is revocable, the income from the funding property will be taxed to the grantor. Even if the trust is irrevocable, however, there are other conditions that will cause the trust income to be taxed to the grantor.

Generally speaking, trust income is taxable to the grantor if the:

(1) grantor or trustee, or both, can revoke the trust without the beneficiary's consent;

(2) trust income is, or in the discretion of the grantor or a non-adverse party, or both, may be (a) distributed to the grantor or the grantor's spouse, (b) accumulated for future distribution to the grantor or the grantor's spouse (Q 143), or (c) applied to pay premiums on insurance on the life of the grantor or the grantor's spouse (Q 142);

1. *Fisher. v. U.S.*, 2008-2 USTC ¶50,481 (Ct. Cl. 2008), *aff'd per curiam*, No. 2009-5001 (Fed. Cir. 2009).
2. 111 AFTR 2d 620 (2013).
3. 877 F. Supp 2d 827, 110 AFTR 2d 2012-5176 (2012).

(3) income is or may be used for the support of the grantor's spouse or is actually used for the support of a person whom the grantor is legally obligated to support, or is or may be applied in discharge of any other obligation of the grantor;

(4) grantor retains certain administrative powers or the power to control beneficial enjoyment of trust principal or income; or

(5) value of a reversionary interest, at the inception of the trust, exceeds 5 percent of the value of the trust.[1]

If the income of the trust is payable to a lineal descendant of the grantor and the trust provides that the grantor's reversionary interest takes effect only on the death of the beneficiary before the beneficiary attains age twenty-one, the income of the trust will not be taxed to the grantor even though the value of the grantor's reversionary interest exceeds 5 percent of the value of the trust.[2]

Planning Point: One of the more common planning strategies involves the "so-called" sale of life insurance to an "intentionally defective trust" or "IDIT." The sale to the IDIT can be a very effective estate planning technique, but it should be remembered that income tax earned by the IDIT will remain taxable to the grantor of the trust. While this may not seem problematic at the time the IDIT is created, in some instances, with good planning and successful investment within the IDIT, situations sometimes arise where the income tax attributable from the IDIT to the grantor can become burdensome. It may be advisable to consider making the IDIT such that the grantor trust power (i.e., the retained power causing grantor trust status for income taxes) can be "turned off" at a future point if the it no longer makes sense that the grantor pay the trust's income taxes. Creating an IDIT should only be done with the assistance of competent tax council.

142. If income of an irrevocable funded life insurance trust is used to pay premiums on a policy insuring the grantor's life, is the income that is used taxable to the grantor?

Yes, unless the policy is irrevocably payable to a charity.[3] It is immaterial whether the insurance is taken out by the grantor before the trust is created or by the trustee after it is created.[4] The rule applies to income used to pay the investment portion of the premium as well as to income used for pure insurance protection.[5] It also applies to income used for policies dedicated to business uses as well as to those for personal estate planning purposes.[6]

Moreover, trust income is taxable to the grantor if, without the approval or consent of an adverse party, it *may* be used for the payment of premiums on insurance on the grantor's life, even though it is not actually used for this purpose. Thus, where policies on the grantor's life

1. IRC Secs. 671-677; Rev. Rul. 75-257, 1975-2 CB 251.
2. IRC Sec. 673(b).
3. IRC Sec. 677(a)(3); *Burnet v. Wells*, 289 U.S. 670 (1933).
4. *Stockstrom v. Comm.*, 3 TC 664 (1944).
5. *Heffelfinger v. Comm.*, 87 F.2d 991 (8th Cir. 1937), *cert. denied*, 302 U.S. 690 (1937).
6. *Vreeland v. Comm.*, 16 TC 1041 (1951).

are placed in the trust, trust income is taxable to the grantor to the extent that the trustee has discretionary power to use it for premium payments.[1]

If the policies are owned by the grantor or by someone other than the trust, however, the trust income is taxable to the grantor only if it actually is used to pay premiums, or if the trustee is specifically authorized to use it for this purpose.[2]

When the trustee is empowered to purchase insurance on the grantor's life, but does not do so, the grantor is not taxed merely because of the trustee's power; there must be policies existing in the tax year during which it would have been possible for the trustee to pay premiums.[3] When a trust beneficiary has voluntarily used income received from the trust to pay premiums on insurance on the grantor's life, the income has not been taxed to the grantor.[4]

Because the law states that the trust income will be taxed to the grantor if it is used to pay the premiums "without the approval or consent of any adverse party,"[5] some have suggested that it may be possible, in some cases, to use trust income for such premium payments. If a beneficiary uses the trust income to pay premiums subject to the grantor's direction or pursuant to an understanding with the grantor, however, the income will be taxable to the grantor.[6] Thus, where the income of a trust for the benefit of grantor's children is to be used for premium payments on insurance on the grantor's life, the income will be taxable to the grantor even though each beneficiary is to consent in writing (revocable at will) to have his or her share of the income applied to the payment of premiums.[7]

143. Can a grantor create an irrevocable funded life insurance trust, carrying insurance on the grantor's spouse, without being taxed on trust income used for premium payments?

No.

The grantor is taxed on trust income used for the payment of insurance premiums on the life of the grantor or the *grantor's spouse*. If the insurance is on the life of someone other than the grantor or the grantor's spouse, however, this provision does not apply. Thus, a grandmother can fund a trust carrying insurance on the life of her son in favor of her grandchildren without being taxed on the trust income under IRC Section 677(a)(3).

144. When is life insurance trust income taxable to some person other than the trust, grantor, or income beneficiary?

A person who has exclusive power to vest the corpus or income of a trust in himself or herself (even though the power cannot be exercised in the case of a minor because no guardian

1. *Rieck v. Comm.*, 118 F.2d 110 (3rd Cir. 1941).
2. *Iverson v. Comm.*, 3 TC 756 (1944); *Weil v. Comm.*, 3 TC 579 (1944), acq.
3. *Rand v. Comm.*, 116 F.2d 929 (8th Cir. 1941) *cert. denied*, 313 U.S. 594 (1941); *Corning v. Comm.*, 104 F.2d 329 (6th Cir. 1939).
4. Booth v. Comm., 3 TC 605 (1944), acq.
5. IRC Sec. 677(a).
6. *Foster v. Comm.*, 8 TC 197 (1947), acq.
7. Rev. Rul. 66-313, 1966-2 CB 245.

has been appointed), or who has released such a power but retained controls similar to those that would subject the grantor to tax, is taxed on the income of the trust (Q 141).[1] If the grantor is taxable on the trust income, however, the other person will not be taxed under this rule, at least with respect to a power to vest income. When a grantor transfers a business interest to a trust, the trust, under certain circumstances, may be viewed by the IRS as a business organization itself.[2]

145. What income is taxable to a life insurance trust?

Generally, a life insurance trust is taxed on: (1) income that, under the terms of the trust, is accumulated for future distribution to someone other than the grantor, and (2) income that the trustee has discretion to accumulate or distribute, but that is not paid or credited to a beneficiary in the taxable year.[3]

146. What income is taxable to the beneficiaries of a life insurance trust?

Trust beneficiaries are taxable on income that is distributed to them, or should have been distributed to them, in the taxable year, to the extent that the income does not exceed the trust's "distributable net income" for the year.[4]

To deter taxpayers from shifting tax liability to a lower bracket beneficiary, trust income taxable to a beneficiary under eighteen years of age may be taxed at the beneficiary's parents' marginal tax rate.

147. May the grantor of a life insurance trust take a deduction for interest paid by the trust on a policy loan when the policy is held by the trust?

If the grantor is taxed as the owner of the trust, the grantor apparently is allowed an interest deduction, in the rare instances when a deduction is allowable, to the same extent as any other owner of the policy (Q 3, Q 30). The IRC provides that when the grantor (or any other person) is treated as the owner of any part of a trust, the trust's deductions, as well as income and credits against tax, attributable to that part of the trust will be taken into account in computing that person's taxable income.[5] Trusts that are treated as owned by the grantor are sometimes referred to as "defective" because, as a general rule, the pass-through of trust income is undesirable. A "defective" trust may be useful, however, if a deduction can be passed through to the grantor. (Where favorable estate tax results are sought, attention also should be given to the matters discussed in Q 173 to Q 181.)

The IRS has ruled privately that where nonadverse trustees had authority to use trust income to pay premiums on policies on the grantor's life (not irrevocably payable for a charitable purpose), or had discretion to pay trust income or principal to the grantor's wife, the grantor would be taxed as owner of the trust and could take the trust's deductions.[6]

1. IRC Sec. 678; Rev. Rul. 81-6, 1981-1 CB 385.
2. See Rev. Rul. 75-258, 1975-2 CB 503.
3. IRC Sec. 641; Treas. Reg. §1.641(a)-2.
4. IRC Secs. 652, 662.
5. IRC Sec. 671.
6. Let. Ruls. 8118051, 8007080, 7909031.

148. Are death proceeds of life insurance taxable income if they are payable to a trust?

No, such proceeds generally are tax-exempt income to the trustee and to the beneficiary when distributed (Q 62, Q 64).

When proceeds are retained by the trust, earnings on the proceeds are taxed in the same manner as other trust income.[1] The $1,000 annual interest exclusion, available where insurance proceeds are payable to a surviving spouse of an insured who died before October 23, 1986, under a life income or installment option, is not available if the proceeds are payable to a trust (Q 70). Under some circumstances, proceeds of a policy transferred for value to a trust may not be wholly tax exempt (Q 264, Q 267).

Gift Tax

149. Is there a gift for gift tax purposes when a grantor transfers a life insurance policy to an irrevocable trust in which the grantor has no interest?

Yes.[2] The value of the gift will be the fair market value of the policy as of the date of the transfer (Q 114). There is no gift if the trust is revocable.[3] An employee's assignment of a group life policy to an irrevocable trust was held not to be a taxable gift because the policy had no ascertainable value (Q 114, Q 154, Q 207).[4]

150. If income-producing property is transferred to an irrevocable life insurance trust to fund premium payments, does the value of the property constitute a gift?

Generally, the full value of the property, in addition to the value of the policy, constitutes a gift. (But see Q 151, relating to reversionary interest trusts.) Subsequent premium payments by the trustee from trust income will not constitute additional gifts from the grantor. This is true even though the insurance is on the life of the grantor and the grantor remains personally liable for the income tax on the trust income, which may be used to pay premiums.[5]

151. How is the gift tax value of a "reversionary interest trust" measured?

A reversionary interest trust is a trust whose property will, on specified circumstances, revert to the grantor.

In a reversionary interest trust, the gift is the right to receive *trust income* during the trust term. The value of this right is determined and taxed in the year the trust is established. The value of the gift generally is the value of the property transferred less the value of the grantor's retained interest.[6] The value of these income and reversionary (or remainder) interests

1. IRC Sec. 101; Treas. Reg. §1.101-1.
2. Treas. Reg. §25.2511-1(h)(8).
3. Treas. Reg. §25.2511-2(c).
4. Rev. Rul. 76-490, 1976-2 CB 300.
5. *Comm. v. Est. of Beck*, 129 F.2d 243 (2d Cir. 1942); *Lockard v. Comm.*, 166 F.2d 409 (1st Cir. 1948).
6. Treas. Reg. §25.2512-9(a)(1)(i).

are determined using the estate and gift tax valuation tables. For example, assuming a valuation table interest rate of 7 percent and a trust term of forty-five years, the value of the gift of income is 0.952387 times the value of the property (1 - 0.047613) (see Appendix C). However, if the reversionary interest is not a qualified interest, the value of the gift is generally the full value of the property transferred to the trust.

Planning Point: To avoid the above result, an annuity or unitrust interest generally should be given to the trust rather than an income interest.

152. Does the transfer of a life insurance policy to an irrevocable trust for the benefit of the grantor's spouse qualify for the gift tax marital deduction?

The gift tax marital deduction generally is not available for a gift in trust unless the donee spouse has at least the right to all the income from the property and a general power of appointment over the principal, or unless the donee spouse's income interest is a "qualifying income interest for life" in the property transferred, in which case the donee spouse does not usually have to have a general power of appointment over the principal. Because a life insurance policy ordinarily does not produce income before maturity, the requirement that the donee spouse receive all the income for life will not be met unless the donee spouse has the power to compel the trustee to convert the policy to income-producing property, or the power to terminate the trust and demand the policy.[1] An annual exclusion may be allowed instead of the marital deduction if the donee spouse is not a U.S. citizen.

153. If a grantor creates a revocable trust with a life insurance policy on the life of another person and names third parties as trust beneficiaries, is a gift made when the insured dies and the trust becomes irrevocable?

Yes. In one case, a wife placed a policy on her husband's life in a revocable trust for their children. It was held that a gift from the wife to the children was made when the insured died and the trust became irrevocable. The value of the gift was the full amount of the death proceeds.[2] If the trust had been irrevocable, the annual premiums paid by the wife, instead of the proceeds, would have constituted gifts.[3]

154. Does the gift of a life insurance policy in trust (or a gift of subsequent premiums) qualify for the gift tax annual exclusion?

In the usual case, no annual exclusions are allowable either on the creation of the trust or on the payment of premiums (Q 214, Q 218).[4]

> *Example*. C transfers certain insurance policies on C's own life to a trust created for the benefit of D. Upon C's death the proceeds of the policies are to be invested, and the net income paid to D during D's

1. Treas. Regs. §§25.2523(e)-1(f)(4), 25.2523(e)-1(f)(6).
2. *Goodman v. Comm.*, 156 F.2d 218 (2d Cir. 1946).
3. *Watkins v. Comm.*, 2 TCM (CCH) 252(1943).
4. Treas. Reg. §25.2503-2; *Comm. v. Boeing*, 123 F.2d 86 (9th Cir. 1941).

lifetime. Because the income payments to D will not begin until after C's death, the transfer in trust represents a gift of a future interest in property against which no exclusion is available.[1]

If the beneficiary were given the power to demand trust principal, apparently the annual exclusion would be available.[2] Such a power, however, would cause the trust principal to be includable in the beneficiary's gross estate.

Where an employee assigned his group life insurance policy to an irrevocable trust, the IRS ruled that subsequent premiums paid by the employer qualified for the annual exclusion as gifts of a present interest by the *employee*. Under the terms of the trust, the beneficiary or the beneficiary's estate was to receive the full proceeds of the policy immediately on the insured's death.[3] In a later ruling, the facts essentially were the same, except that the trust terms directed the trustee to retain the insurance proceeds, paying income to the insured's children for life, with the remainder to the grandchildren; the employer's premium payments following the assignment were held to be gifts of a future interest in property, therefore not qualifying for the annual exclusion.[4] (See also Q 75, Q 163.)

The IRS also has allowed the gift tax annual exclusion when a grantor created a trust with an initial contribution of a $50,000 group term policy on the grantor's life and $1,000 in cash. The trust gave the grantor's spouse a $3,000 annual noncumulative withdrawal right and provided that any asset in the trust, including the insurance policy, could be used to satisfy the demand. The private letter ruling held that the grantor's initial contribution, as well as the grantor's employer's subsequent premium payments on the group term insurance, would qualify for the exclusion.[5]

For a discussion of the special provision with respect to gifts in trust to minors, see Q 155. For a discussion of Crummey withdrawal rights, see Q 156.

155. Is the annual gift tax exclusion available when a life insurance policy is placed in an irrevocable trust for a minor beneficiary?

IRC Section 2503(c) provides that there is a gift of a present interest if the property that constitutes the gift and all income from the property (1) *may* be expended for the benefit of the minor, and (2) *will*, to the extent not so expended, pass to the minor when the minor is age twenty-one, or, if the minor dies before reaching age twenty-one, be payable to the minor's estate or as the minor may appoint under a general power of appointment.[6] The fact that under local law a minor is legally unable to exercise a power or to execute a will does not cause the transfer to fail to satisfy the conditions.[7] Any premiums paid on the policy by the grantor should qualify as gifts of a present interest (Q 218).

1. Treas. Reg. §25.2503-3(c)(Ex. 2).
2. *Halsted v. Comm.*, 28 TC 1069 (1957), acq. 1958-2 CB 5.
3. Rev. Rul. 76-490, 1976-2 CB 300.
4. Rev. Rul. 79-47, 1979-1 CB 312.
5. Let. Rul. 8006109.
6. IRC Sec. 2503(c).
7. Treas. Reg. §25.2503-4.

156. Do transfers to a trustee of an irrevocable life insurance trust of amounts to be used by the trustee to pay premiums qualify for the gift tax annual exclusion?

Although such transfers would ordinarily be future interest gifts, it has been held that they will be treated as present interest gifts, qualifying for the exclusion, to the extent the trust beneficiaries are given immediate withdrawal rights with respect to the amounts transferred.[1] Such trusts are known as *Crummey* trusts, after the case of *Crummey v. Commissioner*.[2]

> *Example*. G creates an irrevocable insurance trust for each of his four children, transferring amounts (additions) from year to year to fund the trusts. Two of the children are minors when the trusts are created and for several years thereafter, but neither has a court-appointed guardian. The trusts provide that with respect to the additions, each child may demand in writing at any time (up to the end of the calendar year in which an addition is made) the sum of $5,000 or the amount of the addition, whichever is less, payable immediately in cash. If a child is a minor when an addition is made, the child's guardian may make such demand on the child's behalf and hold the amount received for the benefit and use of the child. To the extent demands for payment are not made by the beneficiaries, the trustee is directed to use the additions to pay insurance premiums as needed and to purchase additional insurance and investments for the trust. G transfers to each trust $5,000 each year the trusts are in existence. Each trust provides that it is irrevocable for the lifetime of the beneficiary and that the trust assets will revert to the grantor only if the beneficiary dies before age twenty-one. All children survive past age twenty-one. By the rule of the *Crummey* case, G is entitled under present law to $20,000 in gift tax annual exclusions each year ($5,000 for each child). It does not matter that the minor children never had guardians appointed. Had the trusts given the beneficiaries immediate payment rights of no more than $2,000 each with respect to the additions, G's exclusions would be limited to $8,000 per year (assuming he made no other present-interest gifts to his children during the year).

The IRS has ruled that when the beneficiary of a discretionary trust was a competent adult, contributions to the trust did not qualify for the annual exclusion because the beneficiary did not receive timely notice or have actual knowledge of the right to demand immediate distribution of contributions.[3]

Another ruling allowed the annual exclusion where the trust provided for timely written notice to the beneficiaries of their withdrawal rights, and where the beneficiaries were given a 30-day period within which to exercise their withdrawal rights.[4]

Yet another ruling allowed the exclusion where the trust required the trustee to notify the beneficiaries within seven days of receipt of additional contributions and further required that the beneficiaries be given thirty days after receipt of notice within which to exercise their withdrawal rights.[5] If the beneficiary is given reasonable notice of the right to withdraw and a reasonable time within which to exercise the right, the fact that a calendar year ends between the date of the transfer and the date the beneficiary received notice does not transform a present interest gift into a future interest gift.[6]

1. *Crummey v. Comm.*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 CB 321; Let. Ruls. 7826050, 7902007, 7909031, 7947066, 8007080, 8118051, 8445004, 8712014, 9625031.
2. *Crummey v. Comm.*, 397 F.2d 82 (9th Cir. 1968).
3. Rev. Rul. 81-7, 1981-1 CB 474; Let. Rul. 7946007.
4. Let. Rul. 8003033. See also Let. Ruls. 8517052, 8813019.
5. Let. Rul. 8004172.
6. Rev. Rul. 83-108, 1983-2 CB 167.

The annual exclusion was not allowed, however, when the beneficiaries waived their right to receive notice of contributions to the trust with respect to which their withdrawal rights could be exercised. Furthermore, the annual exclusion was not allowed because the grantor set up a trust that provided that notice was to be given to the trustee as to whether a beneficiary could exercise a withdrawal power with respect to a transfer to the trust and the grantor never notified the trustee that the withdrawal powers could be exercised with respect to any of the transfers to the trust. Thus, the gifts were not transfers of a present interest under the meaning of IRC Section 2503(b).[1]

The value of a withdrawal right may be reduced, even to zero, if the trustee has discretion to invade the trust corpus for the benefit of non-*Crummey* beneficiaries.[2] The exclusion is allowed only to the extent there is cash, or assets reducible to cash, in the trust to satisfy any beneficiary demand rights, or to the extent the trustee is required to maintain sufficient liquidity to meet immediate withdrawal demands.[3]

Where appointment of a legal guardian would be necessary to enable a beneficiary to exercise the withdrawal right, sufficient time (at least thirty days) should be allowed to make the appointment before the right to withdraw terminates.[4] "If there is no impediment under the trust or local law to the appointment of a guardian and the minor donee has a right to demand distribution, the transfer is a gift of a present interest that qualifies for the annual exclusion allowable under Section 2503(b) of the Code."[5]

Reciprocal *Crummey* trusts have been unsuccessfully tried in an attempt to increase each donor's annual exclusion. In Revenue Ruling 85-24,[6] A, B, and C, partners in the X partnership, each created a *Crummey* trust for their children. Each contributed $20,000 to the trust initially. A's trust gave his child, F, a power to withdraw $10,000 of the contribution within sixty days, and gave B and C each the power to withdraw $5,000 on the same terms. B's trust gave his child, G, the power to withdraw $10,000, and gave A and C each the power to withdraw $5,000. C's trust gave his child, H, the power to withdraw $10,000, and gave A and B each the power to withdraw $5,000. A, B, and C each claimed a $20,000 gift tax exclusion for the year in which the trusts were created. The IRS ruled that A, B, and C were entitled to only a $10,000 exclusion for the gifts to their children. No gift tax exclusions were allowable with respect to the *Crummey* powers the partners gave one another. These transfers, according to the IRS, were not gifts because they were based on adequate consideration, namely, the consideration for the reciprocal transfers among the partners was each partner's forgoing the exercise of the right of withdrawal in consideration of the other partners' similar forbearance. The IRS said further that upon the lapse of a partner's withdrawal power, the child's gift (from his parent) was increased by $5,000, but the failure of the partner to exercise the power was

1. TAM 9532001.
2. Let. Ruls. 8107009, 8213074.
3. Let. Ruls. 8126047, 8134135. But see also Let. Ruls. 7909031, 8007080, 8006109, 8021058, which allowed the exclusion where liquidity requirements were not clearly stated.
4. Let. Ruls. 8022048, 8134135, 8326074, 8517052, 8610028, 8616027.
5. Rev. Rul. 73-405, 1973-2 CB 321. See also Let. Ruls. 8326074, 8335050, 8517052, 8610028, 8616027, 8701007. But see also *Naumoff v. Comm.*, TC Memo 1983-435, and Let. Rul. 8229097.
6. 1985-1 CB 329.

not considered a lapse of a general power of appointment (i.e., not a gift) because the transfer to the partner was not a gift.

Since August 24, 1981, the IRS has had the following types of *Crummey* insurance trusts under extensive study and has stated that it will not issue rulings or determination letters on the allowability of the gift tax annual exclusion for transfers of property to such trusts until it resolves the issues through publication of a revenue ruling, revenue procedure, or regulation:

(1) The trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse;

(2) 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;

(3) 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;

(4) The trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust; and

(5) 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 IRC Sections 673 to 677.[1]

The IRS has ruled with respect to *Crummey* trusts that the annual exclusion could not be applied to trust contributions on behalf of trust beneficiaries who had withdrawal rights as to the contributions (except to the extent they exercised their withdrawal rights) but who had either no other interest in the trust (a naked power) or only remote contingent interests in the remainder.[2] The Tax Court, however, has rejected the IRS's argument that a power holder must hold rights other than the withdrawal right to obtain the annual exclusion. The withdrawal right (assuming there is no agreement to not exercise the right) is sufficient to obtain the annual exclusion.[3] (Language in *Cristofani* appears to support use of naked powers although the case did not involve naked powers.) The IRS has stated that, applying the substance over form doctrine, the annual exclusions should not be allowed where the withdrawal rights are not in substance what they purport to be in form. If the facts and circumstances show an understanding that the power is not meant to be exercised or that exercise would result in undesirable consequences, then creation of the withdrawal right is not a bona fide gift of a present interest and an annual exclusion should not be allowed.[4]

In TAM 9628004, annual exclusions were not allowed where transfers to the trust were made so late in the first year that *Crummey* withdrawal power holders had no opportunity to

1. Rev. Proc. 2009-3, Sec. 4.46, 2009-1 IRB 107.
2. TAMs 9141008, 9045002, 8727003.
3. *Est. of Cristofani v. Comm.*, 97 TC 74 (1991), acq. in result, 1996-2 CB 1.
4. Action On Decision 1996-010.

exercise their rights, most power holders had either no other interest in the trust or discretionary income or remote contingent remainder interests, and withdrawal powers were never exercised in any year. However, annual exclusions were allowed where the IRS was unable to prove that there was an understanding between the donor and the beneficiaries that the withdrawal rights should not be exercised.[1] In TAM 97310004, annual exclusions were denied where eight trusts were created for eight primary beneficiaries, but *Crummey* withdrawal powers were given to sixteen persons who never exercised their powers; most power holders held either a remote contingent interest or no interest other than the withdrawal power in the trusts in which the power holder was not the primary beneficiary.

Substance over form analysis may be applied to deny annual exclusions when indirect transfers are used in an attempt to obtain inappropriate annual exclusions for gifts to intermediate recipients.[2] For example, suppose that in 2014, A transfers to B, C, and D $14,000 each. By arrangement, B, C, and D each immediately transfer $14,000 to E. The annual exclusion for A's indirect transfers to E is limited to $14,000 and A has made taxable gifts of $28,000 to E. Under the appropriate circumstances, the substance over form analysis might even be used to deny annual exclusions for *Crummey* powers.

157. If the beneficiary of a Crummey trust allows the right to withdraw a contribution to the trust to go unexercised, when will the beneficiary be deemed to have made a transfer subject to gift or estate tax?

The withdrawal power held by a *Crummey* trust beneficiary is a general power of appointment. If a *Crummey* trust provides for a contingent beneficiary to succeed to the interest of the primary beneficiary in the event of the primary beneficiary's death before the trust terminates, the primary beneficiary's failure to exercise the withdrawal right acts as a transfer to the contingent beneficiary, either at the time of the lapse of the withdrawal right or at the time of the primary beneficiary's death. The amount thus transferred is subject to federal gift or estate tax to the extent it exceeds the greater of $5,000 or 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the withdrawal right could be satisfied.[3]

A spouse who was given a withdrawal power would be treated as making gifts to remainder persons each time the spouse allows a withdrawal power to lapse to the extent that the lapsed power exceeds the greater of $5,000 or 5 percent of the trust principal. Furthermore, the value of the gift would not be reduced by the spouse's retained income interest or the spouse's interest in principal subject to an ascertainable standard because such interests are not qualified retained interests under IRC Section 2702.[4]

In those cases, then, in which (1) the primary beneficiary's gift or estate tax liability is to be avoided, and (2) the trust value is less than $280,000 in the case of a $14,000 withdrawal right,

1. *Est. of Kohlsaat*, TC Memo 1997-212; *Est. of Holland v. Comm.*, TC Memo 1997-302.
2. *Heyen v. U.S.*, 945 F 2d 359, 91-2 USTC ¶60,085 (10th Cir. 1991).
3. IRC Sec. 2514(e).
4. Let. Rul. 9804047.

or less than $560,000 in the case of a $28,000 withdrawal right (husband and wife grantors splitting the gift), the "5 or 5" limitation must be dealt with.

Planning Point: A hanging power is one method that has been used in an attempt to manage the "5 or 5" limitation. A hanging power is designed to lapse in any year only to the extent that the power does not exceed the $5,000 or 5 percent ("'5 or 5'" limitation). Any excess is carried over to succeeding years and lapses only to the extent that the power does not exceed the 5 or 5 limitation in such years.

Example. Beginning in 2002, parents transfer an amount equal to eight (2 donors x 4 donees) times the annual exclusion to a trust each year. Four children are each given a right to withdraw an amount equal to two (2 donors) times the annual exclusion annually. Upon non-exercise of the power to withdraw, the power lapses in any year to the extent of the greater of $5,000 or 5 percent of corpus. To the extent that a power does not lapse in a year, it is carried over and added to any power arising in the succeeding year. The hanging power is eliminated in the tenth year (i.e., when carryover equals zero).

YEAR	CORPUS ($)	POWER ($)	LAPSE ($)	CARRYOVER ($)
2002	80,000	20,000	5,000	15,000
2003	168,000	37,000	8,400	28,600
2004	256,000	50,600	12,800	37,800
2005	344,000	59,800	17,200	42,600
2006	432,000	64,600	21,600	43,000
2007	528,000	67,000	26,400	40,600
2008	624,000	64,600	31,200	33,400
2009	720,000	57,400	36,000	21,400
2010	824,000	47,400	41,200	6,200
2011	928,000	32,200	32,200	0

In Letter Ruling 8901004, a hanging *Crummey* withdrawal power written in the form of a tax savings clause was ruled invalid. Many commentators believe that a hanging power that lapses only to the extent that the power does not exceed the 5 or 5 limitation (rather than by reference to whether there would be a taxable gift) would be valid.

A power holder is not treated as making a gift upon the lapse of a general power if the power holder is, in effect, still the owner of the property after the lapse. Consequently, other methods used in an attempt to manage the 5 or 5 limitation include giving the power holder a testamentary limited power to appoint the property to other than the power holder or the power holder's estate, and vesting the property in the power holder.

Under each of these methods for managing the 5 or 5 limitation for gift tax purposes, estate tax inclusion could result (Q 176, Q 200).

Since August 24, 1981, the IRS has had the following types of *Crummey* insurance trust under extensive study and has stated that it will not issue rulings or determination letters on the applicability of IRC Section 2514(e) to a beneficiary's lapse of a withdrawal power when:

(1) The trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse;

(2) 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;

(3) 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;

(4) The trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust; and

(5) 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 IRC Sections 673 to 677.[1]

158. May dividends paid on a life insurance policy in trust be gifts of a present interest even though the policy itself was a gift of a future interest?

Yes. If the trustee is directed to pay the dividends to the trust beneficiary, the value of probable dividends will be considered a gift of a present interest.[2]

Life Insurance: Estate Tax Issues

159. When can a beneficiary of life insurance proceeds be held liable for payment of federal estate tax falling on the insured's estate?

The executor has primary liability for paying federal estate tax and is expected to pay it from the probate estate before distribution.[3] Under IRC Section 2206, unless the decedent has directed otherwise, the executor ordinarily may recover from a named beneficiary such portion of the total tax paid as the proceeds included in the gross estate and received by the beneficiary bear to the taxable estate. In the case of insurance proceeds receivable by the surviving spouse and qualifying for the marital deduction, IRC Section 2206 applies, if at all, only to proceeds in excess of the aggregate amount of the marital deduction allowed the estate. Most states also have apportionment laws under which life insurance beneficiaries share the estate tax burden with estate beneficiaries. It is not entirely clear whether IRC Section 2206 imposes a duty on the executor to seek apportionment, or only gives the executor the power to do so. When the executor is unable to recover a pro-rata share of the estate tax from the beneficiary of the life insurance proceeds, the estate cannot claim a deduction under IRC Section 2054; it is a bad debt and as such is not deductible under IRC Section 2054. A legatee whose share of the estate bears the burden of tax attributable to the proceeds, however, is entitled to a bad debt deduction.[4]

If the government is unable to collect the estate tax from the insured's estate, the tax can be collected from the beneficiary of the life insurance proceeds up to the full amount of the proceeds if the value of the proceeds was includable in the gross estate. Any person

1. Rev. Proc. 2009-3, Sec. 4.46, 2009-1 IRB 107.
2. *Tidemann v. Comm.*, 1 TC 968 (1943).
3. IRC Secs. 2002, 2205.
4. Rev. Rul. 69-411, 1969-2 CB 177.

who receives property includable in a decedent's gross estate under IRC Sections 2034 to 2042 is liable for the tax.[1] It is immaterial that the insured's will directed payment from the insured's general estate.[2] An insurance company holding the proceeds under a settlement option is not liable for the tax.[3] There is a split of authority as to whether transferee liability for interest on any unpaid tax is limited to the amount of proceeds received from the decedent's estate.[4]

Community (Marital) Property

160. How are proceeds of community property life insurance treated in the insured's estate?

Generally speaking, community property is recognized for federal tax purposes as belonging one-half to the husband and one-half to the wife. Consequently, if life insurance proceeds are community property, when the insured spouse dies first, only one-half of the proceeds are includable in that spouse's gross estate regardless of whether they are payable to that spouse's estate, the surviving spouse, or some other beneficiary.[5] Where community proceeds are payable to the insured's estate, only one-half is considered receivable by or for the benefit of the decedent's estate; the other half is received on behalf of the insured's spouse. Where community proceeds are payable to a beneficiary other than the insured's estate, the fact that under local community property law the insured had management powers over the insurance is not construed to mean that the insured possessed incidents of ownership (Q 81) in the insured's spouse's community half.[6] Local community property law determines the nature and extent of ownership of policy proceeds and policy rights. (With respect to life insurance issued under U.S. government programs, see Q 169. See Q 164 for estate tax results where deaths of insured and spouse occur simultaneously.)

161. How are proceeds of community property life insurance treated in the insured's estate in Louisiana?

By way of contrast with the law in other community property states, it has been held under Louisiana law that the presumption of community generally applicable to property acquired with community funds during marriage does not apply to life insurance acquired by a spouse on the spouse's own life payable to the other spouse irrevocably, or on the spouse's life where the spouse has named himself or herself policy owner and revocable beneficiary. In these cases, the policies were held to be the separate property of the noninsured spouse.[7]

1. IRC Secs. 6324(a), 6901; Treas. Reg. §20.2205-1; *U.S. v. Melman*, 398 F. Supp. 87 (E.D. Mo. 1975), aff'd 530 F.2d 790 (8th Cir. 1976).
2. *Lansburgh v. Comm.*, 35 BTA 928 (1937), acq. 143 CB 14; *Matthews v. Comm.*, 9 TCM 397.
3. *John Hancock Mut. Life Ins. Co. v. Comm.*, 128 F.2d 745 (D.C. Cir. 1942).
4. *Baptiste v. Comm.*, 29 F 3d 1533, 94-2 USTC ¶60,178 (11th Cir. 1994), aff'g in part 100 TC 252 (1993); *Baptiste v. Comm.*, 29 F 3d 439, 94-2 USTC ¶60,173 (8th Cir. 1994), cert. den., rev'g in part 100 TC 252 (1993).
5. Treas. Reg. §20.2042-1(b)(2); *DeLappe v. Comm.* (La.) 113 F.2d 48 (5th Cir. 1940); *Howard v. U.S.* (La.) 125 F.2d 986 (5th Cir. 1942); *Est. of Moody v. Comm.* (Tex.) 42 BTA 987 (1940); *Lang v. Comm.* (Wash.) 304 U.S. 264 (1938); *Est. of Levy v. Comm.* (Cal.) 42 BTA 991 (1940); *McCoy v. Comm.* (Cal.) 29 BTA 822 (1934), nonacq. 1934-1 CB 24; *Nance v. U.S.* (Ariz.) 430 F.2d 662 (9th Cir. 1970).
6. Treas. Reg. §20.2042-1(c)(5).
7. *Catalano v. U.S.*, 429 F.2d 1058 (5th Cir. 1969); *Est. of Saia v. Comm.*, 61 TC 515 (1974), nonacq. 1978-2 CB 4; *Bergman v. Comm.*, 66 TC 887 (1976), acq. in result, 1976-2 CB 1.

Under Louisiana law, life insurance proceeds were excluded entirely from an insured decedent's estate where the policy was treated as the separate property of the decedent's spouse and the proceeds were not payable to decedent's estate.[1] In Louisiana, the proceeds of life insurance, if payable to a named beneficiary other than the insured's estate, are not treated as part of the insured's estate and are not subject to community claims.[2] Under Louisiana law, the presumption of community where the policy is purchased with community property applies if one spouse is both the insured and the named owner.[3] Therefore, if a Louisiana decedent purchases a life insurance policy during marriage, names the decedent as owner, and does not transfer ownership of the policy, the proceeds are presumed to be community property and one-half the proceeds are includable in the decedent's estate.[4]

162. When life insurance on the life of a spouse is bought with community funds and one of the spouses is designated the policy owner, is the policy community property or is it the separate property of the spouse designated as the owner?

Life insurance acquired after marriage, with community funds, generally is presumed to be community property, notwithstanding that only one of the spouses is designated the policy owner. The mere act of designating the noninsured spouse as policy owner, say for the purpose of achieving certain tax results, will not of itself rebut the presumption; there must also be clear and convincing evidence that the policy was intended by the spouses to be the separate property of the spouse designated as owner and under his or her sole control. In several cases, and in a revenue ruling, the presumption was *not* rebutted.[5] In several others, the presumption *was* rebutted.[6] In Louisiana, the general presumption that property acquired with community funds during marriage is community property does not apply to life insurance acquired by one spouse under some circumstances (Q 160).

In a 1986 case involving Nevada residents, the Tax Court came to the conclusion that although the decedent/husband/insured and his wife had succeeded in making the insurance policy the separate property of the wife, one-half the death proceeds payable to the wife as beneficiary was nonetheless included in the decedent's estate. Two circumstances accounted for this unusual result: First, the premiums were paid entirely with community property, and second, the insured died in 1978 and within three years of the date the policy was purchased. Following the reasoning in the line of cases represented by *Bel*, *Detroit Bank & Trust Co.*, and *First Nat'l Bank of Oregon*, the Tax Court held that the payment of the premium with

1. Rev. Rul. 94-69, 1994-2 CB 241.
2. *T.L. James & Co., Inc. v. Montgomery*, 332 So. 2d 834 (1976).
3. *Est. of Burris v. Comm.*, TC Memo 2001-210.
4. Rev. Rul. 2003-40, 2003-17 IRB 813.
5. *Comm. v. Fleming*, 155 F.2d 204 (5th Cir. 1946); *Freedman v. U.S.*, 382 F.2d 742 (5th Cir. 1967); *First Nat'l Bank of Midland, Texas (Mathers) v. U.S.*, 69-1 USTC ¶12,574 (1968), rev'd on other grounds 423 F.2d 1286 (5th Cir. 1970); *Lutich v. U.S.*, 29 AFTR2d 1583 (N.D. Cal. 1972); *Est. of Meyer v. Comm.*, 66 TC 41 (1976); *Est. of Madsen v. Comm.*, TC Memo 1979-289, 659 F.2d 897 (9th Cir. 1981); 82-2 USTC ¶13,495 (S.C. Wash. 1982); 82-2 USTC ¶13,500 (9th Cir. 1982), aff'g TC Memo 1979-289; *Daubert v. U.S.*, 533 F. Supp. 66 (W.D. Tex. 1981); Rev. Rul. 67-228, 1967-2 CB 331.
6. *Parson v. U.S.*, 460 F.2d 228 (5th Cir. 1972); *Waite v. U.S.*, 32 AFTR2d 6238 (N.D. Tex. 1973); *Est. of McKee v. Comm.*, TC Memo 1978-108, appeals dismissed; *Kern v. U.S.*, 491 F.2d 436 (9th Cir. 1974); *Est. of Wilmot v. Comm.*, TC Memo 1970-240; *Kroloff v. U.S.*, 487 F.2d 334 (9th Cir. 1973); *Est. of Crane v. Comm.*, TC Memo 1982-174; *Miner v. U.S.*, 50 AFTR2d ¶6,137 (S.D. Tex. 1982), gov't will not appeal; *Est. of Hutnik v. U.S.*, 83-2 USTC ¶13,539 (S.D. Tex. 1983).

community funds amounted to a transfer by the decedent to his wife of his community half of the funds so used, and therefore also amounted to a transfer of the policy itself for purposes of IRC Section 2035.[1]

163. What are the estate tax results in the insured's estate when life insurance premiums have been paid with both community and separate funds?

Where premiums have been paid partly with the insured's separate funds and partly with community funds, one of two basic approaches is taken, depending on local law. Under California and Washington law, a "premium tracing rule" is applied, which says that the proceeds are part separate and part community in the proportion that the premiums were paid with separate and community funds. Accordingly, in estate tax cases involving California and Washington residents in which this issue is presented, the insured's estate includes the proportion of proceeds considered paid for with the insured's separate property and one-half the proportion of proceeds considered paid for with community property.[2]

Louisiana, Texas, and probably New Mexico (and possibly also Arizona) apply the "inception of title" doctrine in determining whether such proceeds are separate or community: proceeds of life insurance bought initially as separate property remain separate property, although the community is entitled to be reimbursed for premiums paid from community funds. Conversely, proceeds of insurance bought initially as community property remain community property, although the separate estate is entitled to be reimbursed for premiums paid from separate funds.

In the case of a Texas decedent who purchased life insurance as separate property, the amount includable in the gross estate as life insurance proceeds under IRC Section 2042 (Q 75) was the face amount of policy proceeds less the amount of premiums paid with community funds. In addition, one-half the premiums paid with community funds was separately includable in the gross estate under IRC Section 2033 as the decedent's interest in community property.[3]

Apparently, in the case of Louisiana decedents, if the proceeds are community property and payable to the insured's estate then none of the proceeds are includable in the decedent's gross estate under IRC Section 2042(2). If the proceeds are community property and payable to a named beneficiary other than the surviving spouse, then the surviving spouse is deemed to have made a gift of the proceeds to that third-party beneficiary on the decedent's death under IRC Section 2511.[4] When the beneficiary is the surviving spouse, however, the treatment will be the same as in the case of a Texas decedent.[5] Nothing is included in the insured's estate if the policy is treated as the separate property of the noninsured spouse and the proceeds are not payable to the insured's estate (Q 160).[6]

There are no rulings or cases on this issue concerning New Mexico or Arizona decedents.

1. *Est. of Hass v. Comm.*, TC Memo 1986-63.
2. Lang v. Comm., 304 U.S. 264 (1938).
3. Rev. Rul. 80-242, 1980-2 CB 276, modifying Rev. Rul. 54-272, 1954-2 CB 298; *Est. of Wildenthal v. Comm.*, TC Memo 1970-119.
4. Rev. Rul. 94-69, 1994-2 CB 241.
5. Rev. Rul. 80-242.
6. Rev. Rul. 94-69, 1994-2 CB 241.

If a resident of a community property state whose law provides that the income from a spouse's separate property is community property makes a gift of property (e.g., life insurance or premium dollars) to his or her spouse, the donor spouse does not, by operation of that law, retain an interest that will cause any portion of the transferred property to be included in the donor's gross estate under IRC Section 2036.[1]

164. When can death proceeds of community property life insurance payable to someone other than the surviving spouse be includable in the surviving spouse's gross estate?

If the insured elects to have death proceeds held under an interest or installment option for the insured's surviving spouse with proceeds remaining at the surviving spouse's death payable to another, a portion of such remaining proceeds may be includable in the surviving spouse's gross estate under IRC Section 2036 as a transfer by the surviving spouse of his or her community property interest with life income retained. Such a transfer will be imputed to the surviving spouse if under state law the insured's death makes the transfer absolute (Q 211). The amount includable is the value of the surviving spouse's community half of the remaining proceeds going to the beneficiary of the remainder interest, less the value (at the insured's death) of the surviving spouse's income interest in the *insured's* community half of the proceeds.[2] In states where the noninsured spouse has a vested interest in the proceeds of community property life insurance (e.g., California and Washington), a gift of the surviving spouse's community property interest should not be imputed to the surviving spouse unless the surviving spouse has consented to or has acquiesced in the insured's disposition of the proceeds.[3] But see, *Est. of Bothun v. Comm.*,[4] decided under California law, where an IRC Section 2036 transfer was imputed to the surviving spouse-primary beneficiary when, because the surviving spouse failed to survive a fifteen-day delayed payment clause, proceeds were paid to the contingent beneficiary. The opinion contained no suggestion of any evidence that the noninsured spouse had consented to the delayed payment clause.

The IRS has ruled that where community property life insurance is payable to a named beneficiary other than the noninsured spouse, if deaths of the insured and the insured's spouse occur simultaneously when both possess the power to change the beneficiary in conjunction with the other, one-half of the proceeds is includable in each spouse's estate without regard to whether local law provides a presumption as to survivorship.[5]

165. How is community property life insurance taxed when the spouse who is not the insured dies first?

One-half of the value of the unmatured policy is includable in the non-insured spouse's gross estate.[6] The value of the policy is determined under Treasury Regulation Section 20.2031-8

1. *Est. of Wyly v. Comm.*, 610 F.2d 1282 (5th Cir. 1980).
2. *U.S. v. Gordon*, 406 F.2d 332 (5th Cir. 1969).
3. See *Whiteley v. U.S.*, 214 F. Supp. 489 (W.D. Wash. 1963).
4. TC Memo 1976-230.
5. Rev. Rul. 79-303, 1979-2 CB 332.
6. *U.S. v. Stewart* (Cal.) 270 F.2d 894 (9th Cir. 1959); *California Trust Co. v. Riddell* 136 F. Supp. 7 (S.D. Cal. 1955); Rev. Rul. 74-284, 1974-1 CB 276 (N.M.).

(Q 195).[1] The amount includable in the estate of the surviving insured spouse upon his or her subsequent death is determined by applying state law to the facts presented to ascertain the extent to which the proceeds are treated as community property or as separate property of the insured.[2]

Dividends

166. How are life insurance paid-up additions purchased with dividends treated for estate tax purposes?

They are treated in the same manner as other insurance. Proceeds are includable in the insured's estate if the proceeds are payable to or for the benefit of the insured's estate, or if the insured has any incidents of ownership in the policy at the time of his or her death (Q 76).[3]

167. What rules are applicable to including life insurance accumulated and post-mortem dividends in an insured's estate?

Accumulated dividends (including interest thereon) and post-mortem dividends are reported together with the face amount of the policy on Schedule D of the insured's estate tax return.[4]

Double Indemnity

168. Are life insurance proceeds paid under a double-indemnity clause includable in an insured's gross estate?

Yes. They are subject to the same rules as other life insurance proceeds and may be included in the insured's gross estate (Q 76, Q 170).[5]

Government Life Insurance

169. Are proceeds of life insurance issued under U.S. government programs includable in the insured's estate?

Yes.

Such proceeds are includable despite a federal law that provides that no tax can be levied on government life insurance. The estate tax is not a tax *on* property itself, but a tax on the right to transfer property at death. Hence, the exemption from taxes does not apply to the estate tax. Proceeds of a policy owned by the insured at the time of his or her death are includable in the insured's estate (government life insurance is nonassignable).[6]

The U.S. Supreme Court has held that community property laws cannot interfere with the right of an insured to name his or her own beneficiary of his or her National Service Life

1. Rev. Rul. 75-100, 75-1 CB 303.
2. See *Scott v. Comm.* (Cal.) 374 F.2d 154 (9th Cir. 1967); *Est. of Cavenaugh v. Comm.* (Tex.), 51 F 3d 597, 95-1 USTC ¶60,195 (5th Cir. 1995), rev'g in part 100 TC 407 (1993); *Est. of Cervin v. Comm.*, 111 F 3d 1252, 97-1 USTC ¶60,274 (5th Cir. 1997), rev'g TC Memo 1994-550; Rev. Rul. 75-100, above (Tex.).
3. IRC Sec. 2042.
4. *See* http://www.irs.gov/pub/irs-pdf/f706.pdf and http://www.irs.gov/pub/irs-pdf/f712.pdf (last accessed January 17, 2014).
5. *Est. of Ackerman v. Comm.*, 15 BTA 635 (1929); *Est. of Wright v. Comm.*, 8 TC 531 (1947); see *Comm. v. Est. of Noel*, 380 U.S. 678 (1965).
6. IRC Sec. 2042; *U.S. Trust Co. of N.Y. v. Helvering*, 307 U.S. 57 (1939); Rev. Rul. 55-622, 1955-2 CB 385.

Insurance (NSLI).[1] Consequently, it has been held that even though an insured and the insured's spouse are residents of a community property state and all premiums have been paid with community funds, the entire proceeds of government life insurance issued to service members and veterans are includable in the insured's gross estate for federal estate tax purposes as if they were the insured's separate property.[2] The Supreme Court of California has held that this ruling is not authority with respect to Federal Employees Group Life Insurance, and that community property rights can be asserted in the proceeds of such insurance notwithstanding the insured's beneficiary designation.[3] If the California decision is followed in the federal courts, then the proceeds from the Federal Employees' Group Life Insurance Program (EGLI) and probably Servicemen's Group Life Insurance as well are includable in the insured's estate on the same basis as the proceeds of regular group life insurance (Q 162 to Q 163). In the case of EGLI, the master policy previously specifically prohibited assignment, but assignment is now permissible (generally, effective October 3, 1994).

Life insurance proceeds were includable in a federal judge's estate where the judge attempted to assign an EGLI policy that was not assignable at the time of the attempted assignment. The judge also attempted to assign the policy after a limited 1984 change in the EGLI law permitted some assignments. However, such attempts were made within three years of the judge's death and were caught by the gifts within three years of death rule (Q 91). The assignments made after the 1984 change in EGLI law were not permitted to relate back to the pre-1984 attempted assignment because assignments were not permissible before 1984.[4]

The IRS has held that in community property states that determine whether life insurance is separate or community property according to the "inception of title" doctrine (Q 163), the proceeds from the NSLI purchased initially as the insured's separate property are separate property even though later premiums were paid with community funds.[5]

Group Life Insurance

170. Are the proceeds of group term life insurance available through an employer includable in an insured's estate?

The general rules for including life insurance proceeds in the gross estate apply (Q 76). Accordingly, the proceeds are includable if they are payable to or for the benefit of the insured's estate, or if the insured possesses any incident of ownership in the policy at the time of his or her death. There is no question, for example, that if at the employee's death the employee possessed the right to designate or change the beneficiary of his or her group life insurance, the employee possessed an incident of ownership within the meaning of IRC Section 2042(2).[6] In addition to the general rules concerning incidents of ownership, in group life insurance, the insured's right

1. *Wissner v. Wissner*, 338 U.S. 655 (1949).
2. *Est. of Hutson v. Comm.*, 49 TC 495 (1968) (NSLI); *Hunt's Estate v. U.S.*, 4 AFTR 2d 5069 (E.D. Tex. 1959) (USGLI); Rev. Rul. 56-603, 1956-2 CB 601 (USGLI, NSLI, and policies issued under the Servicemen's Indemnity Act of 1951).
3. *Carlson v. Carlson*, 11 Cal. 3d 474, 521 P.2d 1114 (1974).
4. *Hays v. U.S.*, 95-2 USTC ¶60,203 (S.D. Ill. 1995).
5. Rev. Rul. 74-312, 1974-2 CB 320.
6. *Chase Nat'l Bank v. U.S.*, 278 U.S. 327 (1929); *Est. of Henry v. Comm.*, TC Memo 1987-119.

to convert to an individual policy on termination of employment is *not* an incident of ownership.[1] Moreover, the power of an employee to effect cancellation of his or her coverage by terminating his or her employment is *not* an incident of ownership.[2]

Estate tax regulations that attribute corporate-held incidents of ownership to an insured who is a stockholder-employee under certain circumstances (Q 302) provide (as amended in 1979) that in the case of group term life insurance, as defined in the regulations under Section 79, the power to surrender or cancel a policy held by a corporation "shall not be attributed to any decedent" through his or her stock ownership.[3] (See Q 225 for the definition of group term life insurance.)

Drawing somewhat of a parallel to the controlling stockholder regulations, the IRS has held that a partnership's power to surrender or cancel its group term life insurance policy is not attributable to any of the partners. According to the IRS, it does not matter that partners do not qualify for the income exclusion provided in IRC Section 79 (Q 229) because they are not employees. Under the facts of the ruling, the insured partner was one of thirty-five partners.[4] The IRS has ruled that optional contributory plans of group life insurance that provide that if an employee opts not to participate on his or her own, certain specified relatives of the employee could, with the employee's consent, apply and pay for the insurance on the employee's life and own all incidents of ownership. The plan also provided that should the third-party applicant-owner cease to qualify as such, the insurance would terminate, in which event the employee would be eligible again to apply for coverage on his or her own. The IRS held that the employee did not possess an incident of ownership within the meaning of IRC Section 2042.[5]

The Tax Court has held that the death proceeds of a combination group term life and disability income policy are taxable for estate tax purposes under IRC Section 2042 as proceeds of life insurance.[6]

171. If an employee assigns his or her incidents of ownership in group term life insurance, are the proceeds includable in the employee's estate?

It is possible for an employee to assign all of the employee's incidents of ownership in group term life insurance so long as both the policy and state law permit an absolute assignment of all the insured's interest in the insurance, including the conversion privilege, if any. If the employee completes such an assignment during his or her lifetime, the employee will be deemed not to have retained an incident of ownership in the insurance under IRC Section 2042(2).[7] In a contributory plan, there is apparently the additional requirement that the assignment must give the assignee the right to continue to pay the insured's share of the premiums.

1. *Est. of Smead v. Comm.*, 78 TC 43 (1982), acq. in result, 1984-2 CB 2; Rev. Rul. 84-130, 1984-2 CB 194, modifying Rev. Rul. 69-54, Situation 2, 1969-1 CB 221; GCM 39272 (8-16-84); AOD 056.
2. Rev. Rul. 72-307, 1972-1 CB 221; *Landorf v. U.S.*, 408 F.2d 461 (Ct. Cl. 1969); *Est. of Lumpkin v. Comm.*, 56 TC 815 (1971), rev'd on other grounds, 474 F.2d 1092 (5th Cir. 1973).
3. Treas. Reg. §20.2042-1(c)(6).
4. Rev. Rul. 83-148, 1983-2 CB 157. GCM 39034 (9-21-83).
5. Rev. Rul. 76-421, 1976-2 CB 280.
6. *Est. of Perl v. Comm.*, 76 TC 861 (1981).
7. Rev. Rul. 69-54, 1969-1 CB 221, as modified by Rev. Rul. 72-307, 1972-1 CB 307, and Rev. Rul. 84-130, 1984-2 CB 194.

Almost all states have enacted laws that specifically permit the assignment of a group policy, including assignment of the conversion privilege. An assignment (including the conversion privilege) of a group policy was held to be effective even though state law neither expressly permitted nor prohibited the assignment.[1] In another case, an assignment was upheld where the master contract permitted the assignment but the individual certificates contained provisions against assignment.[2] An attempted assignment will fail where the terms of the master contract specifically prohibit assignment.[3] In the absence of express statutory permission, establishment of the law may require case-by-case litigation.

172. Is an assignment of group term life insurance within three years before the death of an employee includable in the employee's gross estate?

An assignment of group term life insurance made within three years before the death of the insured will cause the proceeds to be included in the insured's gross estate under IRC Section 2035 (Q 91).[4] It has been held that where a prospective insured applied for group coverage and had ownership of the certificate placed in another, the prospective insured made a transfer of the insurance within the meaning of IRC Section 2035.[5]

Similarly, in *Levine v. U.S.*,[6] where the decedent/insured's controlled corporation procured the insurance and where the insured had his wife sign as the applicant and the beneficiary (the insured died in 1978, within three years of the insurance purchase), the proceeds of the life insurance were includable in the decedent/insured's estate.

The IRS has ruled that an annual renewal of group term insurance by mere payment of the renewal premium does not create a new agreement but merely continues the old agreement, and that, therefore, as to an employee who has assigned his or her coverage, renewal is not a new transfer of insurance coverage for purposes of IRC Section 2035. Therefore, if the insured has transferred the insured's coverage under such a plan more than three years before death, the death proceeds will not be brought back into the insured's estate under IRC Section 2035.[7]

The IRS has also ruled that although (1) an employee cannot, by agreement with an assignee of the employee's life coverage, effectively assign life coverage that the employee may receive in the future furnished by a new insurance carrier, and (2) a change of insurance carrier necessitates a new assignment of an employee's coverage to the same assignee "and the new arrangement is identical in all relevant aspects to the previous arrangement" with the old carrier, the new assignment will not cause the proceeds to be includable in the employee's estate under IRC Section 2035 if the employee dies within three years after the new assignment, but more than three years after the first assignment.[8]

1. *Landorf v. U.S.*, 408 F.2d 461 (1969).
2. *Est. of Gorby v. Comm.*, 53 TC 80 (1969), acq. 1970-1 CB xvi.
3. *Est. of Bartlett v. Comm.*, 54 TC 1590 (1970).
4. Let. Rul. 8022025.
5. *Kahn v. U.S.*, 349 F. Supp. 806 (N.D. Ga. 1972).
6. 10 Cl Ct. 135, 86-1 USTC ¶13,667 (Cl. Ct. 1986).
7. Rev. Rul. 82-13, 1982-1 CB 132.
8. Rev. Rul. 80-289, 1980-2 CB 270, revoking Rev. Rul. 79-231.

A later private ruling dealt with the assignment of the insured's rights in a group life policy that was later replaced by a policy virtually identical in all material respects with the prior policy, but issued by a different carrier. The new policy provided that an employee's irrevocable assignment of the employee's rights in the old policy would be effective to vest in the assignee the insured's rights under the new policy. No new assignment was made after issuance of the new policy. The IRS stated that if applicable local law would not recognize the provision in the new policy as constituting a valid assignment of rights in the new policy, the insured would be treated as the owner of the policy at the insured's death.[1] The U.S. Court of Appeals for the Seventh Circuit held that the proceeds of a group life policy were includable in the decedent's gross estate where the insured died within three years of the issuance of a policy offered by the employer in exchange for an earlier group life insurance policy. In this case, the insured was required to execute a new assignment when the second policy was issued.[2]

Where the issuance of a life insurance policy to a trust created by the insured's children was treated as an exercise of the conversion rights under a group policy in which the insured had held incidents of ownership that the insured had not previously assigned and the insured died within three years of the conversion, the insured was considered to have transferred incidents of ownership in the policy within three years of death, and the proceeds were included in the insured's estate.[3]

Life Insurance Trusts

173. If a grantor creates a revocable life insurance trust with a policy on the grantor's life, will the proceeds be includable in his or her estate?

Yes. The entire value of the proceeds is includable in the grantor's gross estate. If the grantor has funded the trust, the funding property is also includable.[4]

174. If policies on an insured's life are placed in an irrevocable life insurance trust, are the proceeds includable in his estate?

Ordinarily, they are not.[5] The proceeds will be included in the insured's gross estate, however, if the insured retains any incident of ownership in the policy at the time of his or her death, whether the ownership right is exercisable by the insured alone or only in conjunction with another person (Q 76).[6] Even though the insured has assigned the policy to the trustee, the proceeds will be included in the insured's gross estate if, under the terms of the trust instrument, the insured has a right to the cash surrender values.[7] The mere right to give investment advice, in the case of a funded trust, is not considered an incident of ownership in the policy.[8] See Q 91 for tax results where the trust was established within three years of death, or the insured paid

1. Let. Rul. 8230038.
2. *American Nat'l. Bank v. U.S.*, 832 F 2d 1032, 87-2 USTC ¶13,738 (7th Cir. 1987).
3. Let. Rul. 9141007.
4. IRC Sec. 2038(a); Treas. Reg. §20.2042-1(c)(4).
5. *Est. of Crosley v. Comm.*, 47 TC 310 (1966), acq. 1967-2 CB 2.
6. Treas. Reg. §20.2042-1(c)(4); *Farwell v. U.S.*, 243 F.2d 373 (7th Cir. 1957); *In re Rhodes' Est.*, 174 F.2d 584 (3rd Cir. 1949); *Est. of Seward v. Comm.*, 164 F.2d 434 (4th Cir. 1947).
7. *St. Louis Union Trust Co. (Orthwein) v. U.S.*, 262 F. Supp. 27 (E.D. Mo. 1966).
8. *Est. of Mudge v. Comm.*, 27 TC 188 (1956).

premiums within three years of death. On whether the right to control payment of the proceeds when such right is held by the insured as trustee is an incident of ownership, see Q 83.

175. When are death proceeds includable in the estate of a life income beneficiary of a life insurance trust?

If a life income beneficiary is the owner of insurance policies payable to a life insurance trust at the time of the insured's death and the life income beneficiary is still the beneficiary at the time of his or her death, an amount equal to the death proceeds will be includable in the life beneficiary's estate under IRC Section 2036(a)(1) as a transfer of the proceeds with a life income interest retained.[1]

In one case, an insured husband created a nonfunded revocable life insurance trust under which his wife was the life income beneficiary and the wife paid premiums out of her own funds. The court held that on the death of the wife, who died after the husband, the premium payments were not considered transfers, and the proceeds therefore were not includable in her estate under IRC Section 2036(a)(1).[2] However, when a trust is irrevocable, there is a possibility that payment of premiums by the income beneficiary may cause the income beneficiary to be considered a co-grantor of the trust. Thus, the income beneficiary may be considered to have made a transfer with a retained income interest. This would cause the portion of the proceeds attributable to such premiums to be includable in the income beneficiary's estate upon the income beneficiary's subsequent death.[3] Trust beneficiaries would not hold incidents of ownership in life insurance under IRC Section 2042 where (1) a beneficiary could not make contributions to a trust that might hold life insurance on the beneficiary's life and (2) a beneficiary's limited power of appointment could not be exercised if the trust held life insurance on the beneficiary's life.[4]

176. If an income beneficiary has the power to invade the corpus of a trust, will the value of the trust assets over which the income beneficiary has the power be includable in the income beneficiary's gross estate upon the income beneficiary's death?

If the income beneficiary, as the insured's surviving spouse, is given a "qualifying income interest for life" in the trust, the trust corpus (or the specific portion thereof in which the income beneficiary has the income interest) will be includable in the income beneficiary's estate if the marital deduction election is made, whether or not the income beneficiary is given a power to invade the corpus of the trust.[5] If the income beneficiary's interest is not a "qualifying income interest for life" in the trust, if the power is deemed a general power of appointment within the meaning of IRC Section 2041, and if the income beneficiary either (1) possessed the power at death or (2) exercised or released the power during life by a disposition of such a nature that if it were a transfer of property, the property would be includable in the income beneficiary's estate under any of IRC Sections 2035-2038, the value of the trust assets will be includable in the income beneficiary's gross estate.

1. Rev. Rul. 81-166, 1981-1 CB 477.
2. *Goodnow v. U.S.*, 302 F.2d 516 (Ct. Cl. 1962).
3. IRC Sec. 2036(a)(1).
4. Let. Rul. 9602010.
5. IRC Sec. 2044.

In the case of a power created on or before October 21, 1942, property subject to the power would be includable in the income beneficiary's estate under IRC Section 2041 only if the income beneficiary exercised the power by will or as in (2) above.[1] The lapse of a power during the power holder's lifetime is considered a release of such power (as in (2) above), but only to the extent that property that could have been appointed by exercise of the powers that lapsed in any calendar year exceeded in value at the time of the lapse the greater of (a) $5,000, or (b) 5 percent of the value of the assets over which the lapsed powers existed (Q 200).[2]

Subject to the exceptions noted below, the income beneficiary would be deemed to hold a general power of appointment if the income beneficiary had the power to invade the trust corpus for his or her benefit or for the benefit of his or her estate, creditors, or estate creditors. The following powers would *not* be deemed general powers of appointment for purposes of IRC Section 2041 if possessed by the income beneficiary:

1. A power to invade the corpus for the income beneficiary's benefit if the power is limited by an "ascertainable standard" relating to the income beneficiary's "health, education, support, or maintenance."

2. A power of appointment created on or before October 21, 1942, which is exercisable by the income beneficiary only in conjunction with another person.

3. A power of appointment created after October 21, 1942, which is exercisable by the income beneficiary only in conjunction with the creator of the power or with a person having a substantial interest in the property subject to the power adverse to exercise of the power in favor of the income beneficiary.[3]

Five percent of a family trust (as well as 100 hundred percent of a marital trust) was includable in the surviving spouse's estate where the surviving spouse held a power of withdrawal over all of the marital trust and a contingent power to withdraw 5 percent annually from the family trust if the marital trust was exhausted.[4]

In the past, a number of letter rulings have determined that a beneficiary who has the power to remove a trustee will be treated as holding any powers held by the trustee for purposes of determining whether the beneficiary holds a general power of appointment.[5] However, for purposes of IRC Sections 2036 or 2038, the IRS no longer includes trust property in a decedent grantor's estate where the grantor retains the right to replace the trustee but can replace the trustee with only an independent corporate trustee.[6] More recently, the power to remove a trustee and replace the trustee with an independent corporate trustee was not treated as the retention of powers held by the trustee for purposes of IRC Section 2041.[7] This may represent an extension by the IRS of its policy with regard to trustee removal under IRC Sections 2036

1. IRC Sec. 2041(a).
2. IRC Sec. 2041(b)(2).
3. IRC Sec. 2041(b)(1).
4. *Est. of Kurz v. Comm.*, 95-2 USTC ¶60, 215 (7th Cir. 1995).
5. Let. Ruls. 8916032, 9113026 (does not apply to transfers in trust before October 29, 1979, if trust was irrevocable on October 28, 1979).
6. Rev. Rul. 95-58, 1995-2 CB 191; *Est. of Wall v. Comm.*, 101 TC 300 (1993).
7. Let. Rul. 9607008.

and 2038 to IRC Section 2041. Similarly, a beneficiary's right to veto a replacement trustee and to petition a court for appointment of an independent replacement trustee was not treated as a general power of appointment.[1]

See Q 181 regarding the reciprocal trust doctrine.

177. Are life insurance proceeds includable in an insured's estate if they are payable to an irrevocable trust and the trustee has the power to use them for payment of the insured's estate debts and death taxes?

Yes.

Life insurance proceeds are includable in the insured's estate if the trustee is *required* to use the proceeds to discharge estate obligations. The amount of proceeds required for payment of such debts and taxes is includable in the insured's gross estate, whether the proceeds actually are used for such purposes or not.[2] If the trustee's power is merely discretionary, however, and the trust is for the benefit of named individuals, the proceeds are includable in the insured's estate to the extent they are actually used for such purposes.[3] (See also Q 78.)

Planning Point: Liquidity for an insured's estate can be aided by authorizing the trustee to lend proceeds to the estate or to use them to buy assets from the estate; such powers, if only discretionary, should not subject the proceeds to inclusion in the insured's estate.

178. If a grantor funds his or her life insurance trust by transferring income-producing property to the trustee, is the value of the funding property includable in the grantor's gross estate?

It should not be includable in the grantor's estate if, generally, (1) the trust is irrevocable and the grantor has retained no power to alter or amend, (2) the grantor has retained no interest or control over enjoyment of the property or income, and (3) the grantor does not have a reversionary interest in excess of 5 percent.[4] If the grantor retains power to withdraw and surrender policies placed in the trust, the funding property may be includable in the grantor's gross estate.[5]

179. If a grandparent creates a funded irrevocable life insurance trust with policies on the life of his or her child for the benefit of grandchildren, is anything includable in the grantor's gross estate?

Perhaps. If the grandparent retains any interest in or control over the insurance or the funding property, the value of the trust assets at the grantor's death (or at an alternate valuation date), including the insurance policies or proceeds held in trust, could be includable in the

1. Let. Rul. 9741009.
2. Treas. Reg. §20.2042-1(b)(1); *Hooper v. Comm.*, 41 BTA 114 (1940), nonacq. in part at 1941-1 CB 7 (1940); *Pacific Nat'l Bank of Seattle (Morgan Will) v. Comm.*, 40 BTA 128 (1939); *Est. of Rohnert v. Comm.*, 40 BTA 1319 (1939); *Est. of Logan v. Comm.*, 23 BTA 236 (1931).
3. *Est. of Wade v. Comm.*, 47 BTA 21 (1942); *Old Colony Trust Co. (Flye's Est.) v. Comm.*, 39 BTA 871 (1939), acq. 1939-2 CB 27.
4. IRC Secs. 2036, 2037, 2038; *First Nat'l Bank of Birmingham (Est. of Sanson) v. Comm.*, 36 BTA 651 (1937), acq. 1937-2 CB 24; *Est. of Carlton v. Comm.*, 34 TC 988 (1960), nonacq. 1964-1 CB 9; Rev. Rul. 81-164, 1981-1 CB 458.
5. Treas. Reg. §20.2042-1(c)(4); *Est. of Resch v. Comm.*, 20 TC 171 (1953), acq. 1953-2 CB 6.

grandparent's gross estate under one or more of the following IRC Sections: 2036, 2037, 2038, or 2041.[1] The incidents of ownership test of IRC Section 2042 (Q 81) is inapplicable because the grantor is not the insured.

180. How is a "reversionary interest trust" taxed under the estate tax law?

If the trust instrument provides that the trust will end on the grantor's death, the entire value of the property is includable in the grantor's gross estate. Otherwise, the grantor's reversionary interest is includable in his or her estate. The longer the trust has to go, the less will be the value of the reversion in the grantor's estate. This value is determined by use of the Estate and Gift Tax Valuation Tables found in Appendix C. If the gift of the income interest was a taxable gift, the amount of the gift, if not included in the gross estate, will be added to the taxable estate for purposes of computing the tentative estate tax. Nothing will be includable in the *beneficiary's* estate if the trust instrument provides for termination on the beneficiary's death. Otherwise, the value of the right to income will be includable. This value decreases as the trust term draws to a close.[2]

181. What is the reciprocal trust doctrine, and how does it affect life insurance trusts?

Assume there are two insureds, A and B, each of whom wishes to create funded life insurance trusts for the same beneficiaries, with each retaining certain life interests in the property transferred. Each realizes that the retention of such interests will cause the value of the property each transfers to be included in his or her gross estate (Q 177, Q 178). They reason that if they give these interests to the *other*, there should be no basis for includability of the trust assets in their own estates, assuming the trusts are irrevocable.

The reciprocal trust doctrine, developed by the courts, prevents this estate tax result. If the parties were to go ahead with their plan, the doctrine would be applied so as to "uncross" the trusts. For estate tax purposes, A would be treated as grantor of the trusts in form created by B, and vice versa. The doctrine is applied when trusts are interrelated and the arrangement, to the extent of mutual value, leaves the grantors in approximately the same economic position in which they would have been had each retained life interests in the trusts the grantor in form created. There is no need to find that the trusts were exchanged in "payment" for each other, nor that there was a specific "tax avoidance" motive involved in their creation.[3] The U.S. Court of Appeals for the Sixth Circuit and the Tax Court, in split decisions, have held that application of the reciprocal trust doctrine does not require that the grantors have crossed *economic* interests in the trusts they have created.[4] The U.S. Court of Appeals for the Federal Circuit appears to concur with the Tax Court in this view (see case cited below). The reciprocal trust doctrine also has been applied to uncross transfers of assets in custodianship under the Uniform Gifts to Minors Act.[5]

1. *Comm. v. Est. of Arents*, 297 F.2d 894 (2nd Cir. 1962), cert. denied 369 U.S. 848.
2. Treas. Reg. §20.2031-7(d)(2)(ii).
3. *U.S. v. Grace*, 395 U.S. 316 (1969). See also *Est. of Moreno v. Comm.*, 260 F.2d 389 (8th Cir. 1958).
4. *Est. of Green v. U.S.*, 68 F. 3d 151, 95-2 USTC ¶60,216 (6th Cir. 1995); *Est. of Bischoff v. Comm.*, 69 TC 32 (1977).
5. *Exchange Bank & Trust Co. of Fla. v. U.S.*, 694 F. 2d 1261, 82-2 USTC ¶13,505 (Fed. Cir. 1982).

A letter ruling uncrossed reciprocal discretionary distribution rights given to trustees where each trustee was given a discretionary power to make distributions to the other trustee. Consequently, the decedent in this letter ruling was treated as holding a general power to appoint trust corpus to himself and the corpus was included in his estate.[1]

Loans on Life Insurance

182. Is a life insurance policy loan deductible as a claim against the estate?

No. A policy loan is considered an advancement of part of the policy proceeds, not an enforceable claim against the estate.[2] Only the excess of the proceeds over the amount of the policy loan is includable in the gross estate.

Marital Deduction

183. May a trust intended to qualify for the marital deduction as a "power of appointment trust" authorize the trustee to retain or acquire life insurance policies?

Under a "power of appointment trust," the surviving spouse must be entitled for life to all of the income. This condition contemplates a trust holding income-producing property. Thus, if the trustee is empowered to retain or acquire non-income-producing property (such as life insurance), the condition probably will not be satisfied unless the trustee is required to make payments to the surviving spouse out of other trust assets to replace the lost income, or unless the trust gives the surviving spouse the power to compel the trustee to convert the non-income-producing property to income-producing property.[3]

184. May a trust intended to qualify for the marital deduction as qualified terminable interest property (QTIP) authorize the trustee to retain or acquire life insurance policies?

Under a qualified terminable interest property (QTIP) trust, the surviving spouse must be entitled for life to all the income. This condition contemplates a trust holding income-producing property. Thus, if the trustee is empowered to retain or acquire non-income-producing property (such as life insurance), the condition probably will not be satisfied unless the trust gives the surviving spouse the power to compel the trustee to convert the non-income-producing property to income-producing property, or unless the trustee is restrained under a state law "prudent person" rule to treat the surviving spouse fairly by protecting the spouse's income interest.[4]

1. Let. Rul. 9235025.
2. Treas. Regs. §§20.2042-1(a)(3), 20.2053-4; *Kennedy v. Comm.*, 4 BTA 330 (1926).
3. Treas. Regs. §§20.2056(b)-5(f)(4), 20.2056(b)-5(f)(5); Rev. Rul. 75-440, 1975-2 CB 372; *Est. of Robinson v. U.S.*, 1980 US Dist. LEXIS 14673 (E.D. Tenn. 1980).
4. TAM 8745003.

185. If a decedent directs his or her executor or a trustee to buy a nonrefundable life annuity for the decedent's surviving spouse, will the annuity qualify for the marital deduction?

No. The surviving spouse's interest in the annuity is considered a non-deductible terminable interest even though no interest in the annuity has passed from the decedent to any other person.[1] Such an annuity will not fail to qualify, however, if it is bought under a general investment power authorizing investments in both terminable interests and other property.[2]

186. When will life insurance or annuity proceeds payable to the surviving spouse qualify for the marital deduction?

There are five basic arrangements for the payment of proceeds to the surviving spouse that will qualify for the marital deduction:

(1) proceeds payable in a lump sum to the surviving spouse (regardless of whether contingent beneficiaries are named or whether the surviving spouse actually elects to receive the proceeds under a settlement option);[3]

(2) proceeds payable solely to the surviving spouse or to the surviving spouse's estate (Q 187);

(3) proceeds payable to the surviving spouse under a settlement option with contingent beneficiaries named, provided the surviving spouse is given a general power of appointment over the proceeds (Q 188, Q 189);

(4) proceeds of a survivor annuity where only the surviving spouse has the right to receive payments during such spouse's lifetime, unless otherwise elected by the decedent spouse's executor;[4] and

(5) proceeds held under the interest option for the surviving spouse for the surviving spouse's lifetime, when interest is payable to the surviving spouse at least annually, and there is no power in any person to appoint any of the proceeds to anyone other than the spouse during the surviving spouse's lifetime – if the executor elects to have proceeds qualify.

Arrangements (4) and (5) make the proceeds qualified terminable interest property; however, to the extent provided in the regulations, an *annuity* interest is to be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).[5] A specific portion must be determined on a fractional or percentage basis.[6] The proceeds likewise will qualify for the marital deduction if they are payable

1. Treas. Reg. §20.2056(b)-1(c)(2)(i).
2. IRC Sec. 2056(b)(1)(C); Treas. Reg. §20.2056(b)-1(f).
3. Treas. Reg. Sec. 20.2056(c)-2(b)(3)(ii).
4. IRC Sec. 2056(b)(7)(C).
5. IRC Sec. 2056(b)(7)(B)(ii).
6. IRC Sec. 2056(b)(10).

outright to the surviving spouse under the insured's or the annuitant's will or intestate laws, or to a trust that qualifies for the marital deduction. The marital deduction is not available unless the insured or annuitant is actually survived by his or her spouse, or is legally presumed to have been survived by his or her spouse (Q 192). Thus, a provision in the disposing instrument that the proceeds are payable to the spouse on the sole condition that the spouse survive the insured or annuitant will not disqualify the proceeds (Q 190, Q 191).

A marital deduction generally is not allowable when the surviving spouse is not a U.S. citizen unless the transfer is to a qualified domestic trust.

187. Will life insurance or annuity proceeds qualify for the marital deduction if they are payable to the surviving spouse under a settlement option with the surviving spouse's estate designated as contingent beneficiary? What if they are payable to the surviving spouse as a straight life annuity?

If the proceeds are payable only to the surviving spouse or to his or her estate, they will qualify.[1] For example, the following settlement would qualify: life income to a widow with a twenty-year certain period, and should she die within the twenty-year period, the balance of the guaranteed payments to be commuted and paid to her estate. The following settlement also would qualify: interest to widow for life, and principal to her estate at her death. Likewise, the proceeds will qualify if they are payable to the surviving spouse under a straight life annuity settlement with no refund or period-certain guarantee (no portion of the proceeds would be payable to any other person after her death).[2]

If proceeds are payable under a no-refund life annuity to the surviving spouse, qualification is not affected by the fact that an annuity also is payable to another, so long as the respective rights to their annuities are not tied together in any way.[3] When only the surviving spouse has the right to receive payments from a survivor annuity during such spouse's lifetime, such proceeds are treated as qualified terminable interest property unless otherwise elected by the decedent spouse's executor.[4]

188. Can life insurance settlements naming the spouse as primary beneficiary and other persons as contingent beneficiaries be arranged so that the proceeds qualify for the marital deduction?

Yes.

When there is a possibility that one or more persons may receive some unpaid proceeds after the spouse's death, the spouse receives only a *terminable interest* in the proceeds. As a rule, terminable interests do not qualify for the marital deduction. As an exception to the general rule, however, a settlement naming contingent beneficiaries will qualify if the spouse is given a general power of appointment over the proceeds and certain other requirements are met.

1. IRC Sec. 2056(a); Treas. Reg. §20.2056(c)-2(b)(3).
2. Treas. Reg. §20.2056(b)-1(g), Example (3).
3. Rev. Rul. 77-130, 1977-1 CB 289.
4. IRC Sec. 2056(b)(7)(C).

Specifically, an insured may elect an interest-only, life income, or installment option for his or her spouse, naming contingent beneficiaries to receive the proceeds after the spouse's death, and the proceeds will qualify, provided the settlement meets the following conditions:

(1) The interest or installments must be payable annually or more frequently, and the first payment must be payable no later than thirteen months after the insured's death;

(2) All amounts payable during the spouse's life must be payable only to the spouse;

(3) The spouse must have a *general power of appointment* over the proceeds (a power to appoint the proceeds to himself or herself or to his or her estate – see Q 189);

(4) The spouse's power to appoint must be exercisable by the spouse alone and in all events, whether exercisable by will or during life; and

(5) The proceeds must not be subject to a power in any other person to appoint against the spouse.[1]

An alternative settlement naming contingent beneficiaries does not require that the spouse be given any power over the proceeds so long as the spouse has a "qualifying income interest for life" in the proceeds, and so long as the executor elects to have such proceeds qualify for the marital deduction. The surviving spouse has a "qualifying income interest for life" if he or she is entitled to all the income from the proceeds, payable annually or more frequently, and no person has a power to appoint any part of the proceeds to any person other than the surviving spouse. The insured or anyone else, including the surviving spouse, can designate beneficiaries to receive proceeds remaining at the spouse's death, and the spouse may be (but need not be) given the right to withdraw proceeds during his or her lifetime (Q 186).

It is not necessary that the entire proceeds qualify. If a specific portion of the proceeds meets the conditions outlined above, that specific portion will qualify for the deduction.[2]

The specific portion, however, must be determined on a fractional or percentage basis.[3]

189. What is a general power to appoint the proceeds of a life insurance policy for purposes of the marital deduction?

For purposes of the marital deduction, the donee of a general power of appointment must have the power to appoint the property to himself or herself or to his or her estate.[4] Thus, if the surviving spouse-beneficiary has the power to revoke contingent beneficiaries and name his or her estate instead, the surviving spouse-beneficiary is deemed to have a general power to appoint to his or her estate. Or, if the surviving spouse-beneficiary can withdraw the principal

1. IRC Sec. 2056(b)(6); Treas. Reg. §20.2056(b)-6; *Est. of White v. Comm.*, 22 TC 641 (1954); *Est. of Zeman v. Comm.*, TC Memo 1958-68; *Est. of Fiedler v. Comm.*, 67 TC 239 (1976), acq. 1977-1 CB 1; Rev. Rul. 76-404, 1976-2 CB 294.
2. IRC Secs. 2056(b)(6), 2056(b)(7); Treas. Reg. §20.2056(b)-6(b).
3. IRC Sec. 2056(b)(10).
4. IRC Sec. 2056(b)(6).

sum for his or her own use, the surviving spouse-beneficiary is deemed to have a general power to appoint to himself or to herself or to his or her estate.[1] The surviving spouse-beneficiary need not possess both powers; either will suffice. The term "power to appoint" need not be used in the insurance policy. Thus, even where the surviving spouse is not given the power to revoke contingent beneficiaries, the proceeds will qualify if the surviving spouse is given the power to withdraw the proceeds during his or her life and the power is exercisable *in all events*. Insurance companies normally impose some administrative restrictions on the exercise of withdrawal rights. Regulations state, however, that limitations of a formal nature – such as requirements that reasonable intervals must elapse between partial exercise – will not cause disqualification.[2]

190. Does the use of a "delay clause" disqualify life insurance proceeds for the marital deduction?

A "delay clause" is a provision that may be inserted into life insurance contracts providing that a surviving spouse will only be paid if alive at the end of a certain period of time after the death of the first spouse. The "delay clause" will not disqualify the proceeds unless the delay period specified is for more than six months. For example, the beneficiary arrangement may provide that payment will be made to the insured's spouse if the spouse is living at the end of sixty days after the insured's death, otherwise payment is to contingent beneficiaries.

Under the general rules, a delay clause would create a terminable interest and, accordingly, disqualify the proceeds. The reason is that such a clause creates a possibility that the surviving spouse's interest will end (if the surviving spouse dies within the delay period) and the contingent beneficiaries will receive the proceeds. Under a specific exception, however, such a clause will not disqualify the proceeds if: (1) the delay period does not exceed six months, and (2) the surviving spouse actually survives the delay period. However, any clause that creates the possibility that the surviving spouse may have to survive longer than six months to receive the proceeds ordinarily will disqualify the proceeds for the marital deduction – even though the spouse survives the period and actually receives the proceeds.[3]

Planning Point: Although – because of the special exception – a delay clause does not always result in loss of the marital deduction, the clause should not be used when it is important to secure the marital deduction with respect to the proceeds for the insured's estate or else a lose-lose situation will be created. If the spouse survives the delay period, the clause will have served no purpose. If the surviving spouse does not live through the full delay period, the clause will result in loss of the marital deduction.

191. Does a common disaster clause disqualify life insurance proceeds for the marital deduction?

Where a true common disaster clause is used, the beneficiary-spouse will not receive the proceeds if he or she dies of injuries sustained in the same accident (or other disaster) that causes the death of the insured, regardless of how long that spouse actually survives the insured.

1. Treas. Reg. §20.2056(b)-6(e)(4); Rev. Rul. 55-277, 1955-1 CB 456.
2. Treas. Reg. §20.2056(b)-5(g)(4). See also *Est. of Cornwell v. Comm.*, 37 TC 688 (1962), acq. *Est. of Jennings v. Comm.*, 39 TC 417 (1962), acq.
3. IRC Sec. 2056(b)(3); Treas. Reg. §20.2056(b)-3(b); Rev. Rul. 54-121, 1954-1 CB 196; TAM 8747003; but see *Eggleston v. Dudley*, 257 F.2d 398 (3rd Cir.). See also Rev. Rul. 70-400, 1970-2 CB 196.

A common disaster clause creates a terminable interest. But as a special exception to the terminable interest rule, a clause will not disqualify the proceeds unless the death of the insured and that of the spouse actually are caused by the same disaster.[1] A true common disaster clause is seldom used in an insurance policy.

192. Can operation of the Uniform Simultaneous Death Act result in loss of the marital deduction?

Yes.

If the insured and spouse-beneficiary die under circumstances that make it impossible to determine the order of death (usually when both are killed in the same accident), the Uniform Simultaneous Death Act creates a presumption that the *beneficiary* died first. Because it is presumed that the spouse-beneficiary did *not* survive, the act would result in loss of the marital deduction. It is possible to reverse the statutory presumption, however, by inserting a so-called "reverse simultaneous death clause" in the policy. This clause provides that, if the order of death cannot be determined, it will be presumed that the insured died first. This would save the marital deduction.[2] It cannot save the marital deduction, however, if there is evidence that the beneficiary actually died first.

193. Can proceeds of community property life insurance passing to the surviving spouse qualify for the marital deduction?

Yes, and without limit as to amount.[3]

Multiple-Life Life Insurance

194. Does estate taxation of a life insurance policy that insures more than one life differ from taxation of a policy that insures a single life?

Basically, no. Application of the rules, however, generally depends on when proceeds are payable. With a "first-to-die" or "joint life" policy, proceeds are payable at the death of the first insured to die. With a "second-to-die," "survivorship," or "joint and survivor" policy, proceeds are payable at the death of the last survivor.

In general, proceeds of a first-to-die policy will be included in the insured's estate if the proceeds are payable to or for the benefit of the insured's estate, or if the insured held incidents of ownership in the policy at death or within three years of death (Q 76). Also, the value of a first-to-die policy will be included in the estate of a policy owner who is not the insured (Q 195).

The value of a second-to-die policy will be included in the estate of a policy owner who is not the insured (Q 195). For the same reasons, at the first death, the value of a second-to-die policy will be included in the estate of the decedent/insured if the decedent/insured is

1. IRC Sec. 2056(b)(3).
2. Treas. Reg. §20.2056(c)-2(e).
3. IRC Sec. 2056.

a policy owner. At the second death, proceeds of a second-to-die policy will be included in the insured's estate if (1) the proceeds are payable to or for the benefit of the insured's estate, or (2) the insured held incidents of ownership in the policy at death or within three years of death (Q 76).

Planning Point: Second-to-die policies frequently are used to provide for estate taxes deferred through use of the marital deduction until the surviving spouse's death. First-to-die policies frequently are used to provide funds for a buy-sell agreement or to provide some funds at the death of the first spouse to die.

For income taxation of multiple-life life insurance, see Q 138. For gift taxation of multiple-life life insurance, see Q 206.

Policyholder Other Than Insured

195. If a policy owner who is not the insured dies before the insured, is the value of the unmatured life insurance policy included in the policy owner's gross estate?

Yes.[1] The value of the policy is determined in the same manner as for gift tax purposes, substituting the date of death for the date of the gift (Q 114).[2]

A revenue ruling involved the estate tax valuation of a third-party-owned policy on the split-dollar plan (Q 3898). The policy had been in force for some time and premiums remained to be paid after the decedent policy owner's death. Premiums and proceeds were split between the decedent and the insured's employer, to whom the policy had been collaterally assigned. It was ruled that the amount includable in the decedent's estate was the interpolated terminal reserve plus the proportionate part of the gross premium paid before the date of the decedent's death that covered the period extending beyond that date, less the amount of the employer's interest in the policy.[3]

Where the executor elects to value assets six months after death (alternate valuation), any increase in policy value due to payment of premiums or accrual of interest during the six months following death is excluded in determining the estate tax value of the policy.[4] But if the executor elects to value the estate by the alternative valuation method, and the insured dies before the optional valuation date (six months after the policy owner's death), the entire value of the proceeds is includable in the policy owner's gross estate.[5]

Where the owner-beneficiary of a life insurance policy and the insured die simultaneously (to all appearances), and where policy proceeds are distributed as if the owner-beneficiary predeceased the insured (as provided in the Uniform Simultaneous Death Act, except where the policy or other controlling instrument provides otherwise), the value of the policy

1. IRC Sec. 2033.
2. Treas. Reg. §20.2031-8; *DuPont Est. v. Comm.*, 233 F.2d 210 (3rd Cir. 1956); *Est. of Donaldson v. Comm.*, 31 TC 729 (1959).
3. Rev. Rul. 79-429, 1979-2 CB 321.
4. Rev. Rul. 55-379, 1955-1 CB 449.
5. Rev. Rul. 63-52, 1963-1 CB 173.

(valued as described above) is likewise included in the owner-beneficiary's estate under IRC Section 2033.[1]

In Revenue Ruling 77-181, A and B each owned policies on the other's life with proceeds payable to the owner or the owner's estate. A and B died under circumstances in which the Uniform Simultaneous Death Act provisions applied, so that the proceeds of the policies on A's life were paid to B's estate and the proceeds of policies on B's life were paid to A's estate. The IRS ruled that the amount to be included in the gross estate of each was the sum of the date-of-death interpolated terminal reserve value of the policies each decedent owned at death and the proportionate part of the gross premium last paid covering the post-death period. Where, in the instrument controlling disposition of policy proceeds, the presumed order of the deaths is reversed from that provided in the uniform act, simultaneous deaths of the policy owner-beneficiary and the insured will cause the death proceeds to be includable in the policy owner's estate.[2] (See also Q 209.)

Settlement Options – Beneficiary's Estate

196. If the insured elects a settlement option for the insured's primary beneficiary and names contingent beneficiaries, will the value of any unpaid life insurance proceeds be includable in the primary beneficiary's estate?

As a general rule, proceeds are not includable in the primary beneficiary's estate unless the primary beneficiary has a general power of appointment over the proceeds (Q 189, Q 197) or was the insured's surviving spouse and has a "qualifying income interest for life" in proceeds as to which the marital deduction was allowed (Q 188).[3] The transfer to contingent beneficiaries is from the insured, not from the primary beneficiary. (For a limited, noncumulative power to withdraw, see Q 200.) With respect to community property insurance, however, one-half of the proceeds belongs to the noninsured spouse (assuming policy premiums were paid with community property funds). Consequently, when the noninsured spouse is the primary beneficiary, one-half of the proceeds will be includable in the insured spouse's estate, and one-half of the value of the proceeds remaining at the noninsured spouse's death will be includable in the noninsured spouse's estate.[4]

197. If the surviving income beneficiary dies possessing the power during his or her lifetime to appoint the life insurance proceeds only to his or her children, are the proceeds includable in the surviving income beneficiary's estate?

If the surviving spouse has a "qualifying income interest for life" in the proceeds, the proceeds will be includable in the surviving spouse's estate if the marital deduction election

1. *Chown v. Comm.*, 428 F.2d 1395 (9th Cir. 1970); *Old Kent Bank & Trust Co. v. U.S.*, 430 F.2d 392 (6th Cir. 1970); *Meltzer v. Comm.*, 439 F.2d 798 (4th Cir. 1971); *Wien v. Comm.*, 441 F.2d 32 (5th Cir. 1971); Rev. Rul. 77-181, 1977-1 CB 272; *Est. of Goldstone v. Comm.*, 78 TC 1143 (1982).
2. Rev. Rul. 77-48, 1977-1 CB 292.
3. IRC Secs. 2041, 2044.
4. IRC Sec. 2036. *Whiteley v. U.S.*, 214 F. Supp. 489 (W.D. Wash. 1963). See *Tyre v. Aetna Life Ins. Co.*, 353 P. 2d 725 (Cal. 1960).

was made regardless of whether the surviving spouse has any power to appoint the proceeds (Q 188).[1] If the surviving spouse does not have a "qualifying income interest for life" in the proceeds, according to a 1979 revenue ruling, the answer depends on whether the income beneficiary at the surviving spouse's death could have discharged his or her legal duty to support the children, in whole or in part, by exercising the power to appoint the proceeds. To the extent the surviving spouse could have appointed the proceeds, the power would be treated as a general power of appointment and the proceeds would be includable. Under the facts of the ruling, it was held that no part of the proceeds was includable because all of the income beneficiary's children were adults at the time of the surviving spouse's death and the surviving spouse was not obligated under local law to provide for their support.[2] See Q 181 regarding the reciprocal trust doctrine.

198. If life insurance proceeds are payable to the surviving spouse's estate, but remain unpaid at the primary beneficiary's death, is the money includable in the primary beneficiary's gross estate?

Yes. Because the beneficiary can dispose of the remaining proceeds as desired through a will, the beneficiary is deemed to have a general power of appointment over the proceeds (Q 189).[3]

199. If an insured elects a settlement option naming contingent beneficiaries, but still gives the primary beneficiary power to withdraw proceeds, are life insurance proceeds remaining unpaid at the primary beneficiary's death includable in the primary beneficiary's estate?

If the primary beneficiary has a "qualifying income interest for life" in the proceeds, the proceeds will be includable in the primary beneficiary's estate if the marital deduction election was made, whether the primary beneficiary has a power to withdraw any of the proceeds or not (Q 188).[4] Otherwise, a full power of withdrawal constitutes a *general power of appointment* (Q 189).[5] Whether the possession of such a power by the primary beneficiary will cause the remaining proceeds to be taxable in the primary beneficiary's estate depends upon when the power was created. If the primary beneficiary has an unrestricted power to withdraw the proceeds, and the power was created after October 21, 1942, the value of any proceeds remaining unpaid at the primary beneficiary's death will be included in the primary beneficiary's gross estate.[6] (For a limited, noncumulative withdrawal right, see Q 200.) If the primary beneficiary's power of withdrawal was created before October 22, 1942, the value of the unpaid proceeds is not includable in the primary beneficiary's gross estate merely because the primary beneficiary possessed the power.[7] A power of appointment is created when the insured executes the supplementary

1. IRC Sec. 2044.
2. Rev. Rul. 79-154, 1979-1 CB 301.
3. IRC Sec. 2041(a); Rev. Rul. 55-277, 1955-1 CB 456; *Keeter v. U.S.*, 461 F. 2d 714, 29 AFTR 2d 72-1540 (5th Cir. 1972). Contra, *Second Nat'l Bank of Danville, Ill. v. Dallman*, 209 F.2d 321 (7th Cir. 1954).
4. IRC Sec. 2044.
5. Treas. Reg. §20.2056(b)-6(e)(4).
6. IRC Sec. 2041(a)(2).
7. IRC Sec. 2041(a)(1).

contract electing the settlement option. This is the date the power is created even though the insured retains the right to surrender the policy and to change the beneficiary.[1]

200. Can an insured give a primary beneficiary limited, noncumulative withdrawal rights without causing any remaining unpaid life insurance proceeds to be includable in the primary beneficiary's estate?

If the insured gives a primary beneficiary (e.g., a spouse) a "qualifying income interest for life" in the proceeds, the proceeds will be includable in the primary beneficiary's estate if the marital deduction election was made, regardless of whether the primary beneficiary has a power to withdraw any of the proceeds (Q 188).[2] If the primary beneficiary does not have such an interest in the proceeds, the insured can give a beneficiary a noncumulative right to withdraw each year up to $5,000 or 5 percent of the balance of the proceeds, whichever is greater. If the beneficiary's annual withdrawal right does not exceed these limits, the amounts the primary beneficiary could have withdrawn but did not withdraw are not includable in the primary beneficiary's gross estate (except the unwithdrawn amount that the primary beneficiary could have withdrawn in the year of his or her death).[3]

> *Example*. The proceeds of a $100,000 life insurance policy are left with the insurer under the interest-only option for the insured's daughter. The daughter is given a noncumulative right to withdraw $5,000 a year. She does not have a power to appoint the proceeds to her estate. The daughter dies seven years later, having withdrawn none of the proceeds. Only $5,000, the amount she could have withdrawn in the year of death, is includable in her gross estate.[4]

If the beneficiary's noncumulative withdrawal right exceeds the $5,000/5 percent limits, the aggregate withdrawable amounts in excess of these limits that the beneficiary did not withdraw will be includable in the beneficiary's gross estate (but not in excess of the full proceeds). Thus, if the daughter in the example above had a power to withdraw $6,000 annually, and she did not withdraw the excess amount, then the amount includable in her gross estate would be $12,000 [6 × $1,000 (amount in excess of $5,000 for six years) + $6,000 (year of death)].

201. If the primary beneficiary is given the power to revoke contingent beneficiaries and appoint to his or her estate under a settlement option, are life insurance proceeds remaining unpaid at the primary beneficiary's death includable in his or her estate?

If a beneficiary has the power to appoint to his or her estate, then the beneficiary has a general power of appointment over the proceeds.[5] Generally, such a power, given to a surviving spouse-beneficiary, will qualify the proceeds for the marital deduction in the insured's estate (Q 188), but will cause remaining unpaid proceeds to be includable in the beneficiary's estate. However, includability in the beneficiary's estate will depend on when the power was created. If the power was created *after* October 21, 1942, the proceeds remaining unpaid at the

1. Treas. Reg. §20.2041-1.
2. IRC Sec. 2044.
3. IRC Sec. 2041(b)(2).
4. Rev. Rul. 79-373, 1979-2 CB 331.
5. Treas. Reg. §20.2056(b)-6(e)(4).

primary beneficiary's death are includable in his or her estate.[1] If the power was created *before* October 22, 1942, the proceeds remaining unpaid at the beneficiary's death are includable in his or her estate only if the beneficiary exercised the power. (See Q 199 with respect to when a power is created.)

202. If a beneficiary elects the settlement option, are life insurance proceeds remaining unpaid at the beneficiary's death includable in his or her estate?

Yes. If proceeds are payable to a beneficiary in a lump sum and, after the insured's death, the beneficiary elects a settlement option as primary beneficiary, the proceeds are includable in his or her estate.[2] Likewise, if the beneficiary as *policy owner* elects a settlement for himself or herself and contingent beneficiaries, the remaining proceeds are includable in the beneficiary's gross estate.[3]

203. How are life insurance proceeds valued for an insured's estate tax return?

The full face amount plus paid-up additions, accumulated dividends (with interest thereon), and post-mortem dividends, less policy loans, should be included in Schedule D of the estate tax return.[4] The date-of-death value is used, regardless of whether the executor elects the optional alternative valuation date.[5]

204. If the amount of life insurance proceeds collectible from the insurer is not determinable when the estate tax return is filed, what amount is reportable on the return?

The unsatisfactory answer appears to be that a determination of the fair market value of the insurance claim or claims at the date of death or at the alternate valuation date must be made from the facts and circumstances of the particular case.[6] This problem is most likely to be encountered when an insured's death occurs during the policy's contestable period and there is a question whether the insured made material misrepresentations in applying for the insurance or whether the insured's death resulted from suicide.

Gift Tax Issues

205. Can gift tax be collected from the donee of a life insurance policy or proceeds?

Yes. If the gift tax is not collected from the donor, the donee is liable for the tax. The government can collect the gift tax from the donee-beneficiary, and the latter's liability is not limited to the policy's cash value.[7]

1. IRC Sec. 2041(a)(2).
2. IRC Sec. 2036; *Est. of Tuohy v. Comm.*, 14 TC 245 (1950); *Rundle v. Welch*, 184 F. Supp. 777 (S.D. Ohio 1960); Let. Rul. 8051019.
3. *Est. of Pyle v. Comm.*, 313 F.2d 328 (3rd Cir. 1963).
4. See Estate Tax Form 706, Schedule D, and Form 712. Treas. Reg. §20.2042-1(a)(3).
5. Rev. Rul. 58-576, 1958-2 CB 625.
6. *American Nat'l Bank & Trust Co. v. U.S.*, 594 F.2d 1141 (7th Cir. 1979); Let. Rul. 8308001.
7. IRC Sec. 6324(b); *Comm. v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958).

206. Does gift taxation of a life insurance policy that insures more than one life differ from taxation of a policy that insures a single life?

Basically, no. However, application of the rules may depend on when proceeds are payable. With a "first-to-die" or "joint life" policy, proceeds are payable at the death of the first insured to die. With a "second-to-die," "survivorship," or "joint and survivor" policy, proceeds are payable at the death of the last survivor.

Thus, with a "first-to-die" policy, a policy owner who is not the insured may be treated as making a gift to beneficiaries when an insured dies. Also, with a "second-to-die" policy, at the second death, a policy owner who is not the insured may be treated as making a gift to beneficiaries (Q 209).

Planning Point: Second-to-die policies generally are viewed as providing low-cost premiums for gift tax purposes; conversely, first-to-die premiums generally appear high compared to premiums to insure one life.

For income taxation of multiple-life life insurance, see Q 138. For estate taxation of multiple-life life insurance, see Q 194.

207. Do premiums gratuitously paid on life insurance owned by and payable to another constitute gifts?

Generally, yes. If an individual pays a premium on a life insurance policy in which he or she has no ownership rights, the individual has made a gift of the premium.[1] Where, for example, a wife paid premiums on a policy owned by her husband and payable to his estate, she was held to have made a gift to her husband even though she had a contingent interest in the policy as a beneficiary of his estate. Under present law, however, such a gift would qualify for the unlimited marital deduction (Q 109).[2] A gift of premiums may qualify for the gift tax annual exclusion (Q 213).

Ordinarily the premium payer will be considered the donor. However, where an employee assigned his group life insurance policy to an irrevocable trust he had created for his beneficiary, the IRS ruled that premiums subsequently paid by the employer were gifts from the *employee* to the trust.[3] (See also Q 149, Q 154.)

208. Do premiums paid by one of several beneficiaries of an irrevocable life insurance trust constitute gifts to the other beneficiaries?

Yes. Premiums paid in excess of the amount necessary to protect one beneficiary's actuarially determined interest constitute gifts to the other beneficiaries.[4]

1. *Comm. v. Boeing*, 123 F.2d 86 (9th Cir. 1941).
2. *Harris v. Comm.*, 10 TC 741 (1948), nonacq. 1948-2 CB 5.
3. Rev. Rul. 76-490, 1976-2 CB 300; Rev. Rul. 79-47, 1979-1 CB 312.
4. *Comm. v. Berger*, 201 F.2d 171 (2nd Cir. 1953).

209. If a life insurance policy is owned by someone other than the insured, is there a gift when the insured dies and the proceeds are paid to the owner's designated beneficiary?

Yes. For example, if a wife owns a policy on the life of her husband and their children are named beneficiaries, subject to the wife's right to change beneficiaries, there is a gift from the wife to the children when her husband (the insured) dies. The value of the gift would be the value of the entire proceeds.[1] Under such circumstances, the gift of the proceeds will *not* be considered a split gift between the wife and her late husband-insured under IRC Section 2513 (Q 112), even if the executor signs a "consent of spouse" and files a gift tax return on behalf of the deceased spouse.[2]

In another example: A bought insurance on the life of B, revocably designating Y as beneficiary; Y is trustee of a trust established by A. The trust provided that trust income was payable to B for life, then to A for life, then trust corpus to the children of A and B. The trust also provided that for purposes of the trust agreement, if A and B died simultaneously, A would be presumed to have survived B. A and B died simultaneously. It was held that there was a taxable gift of the proceeds from A to the children of A and B.[3] (See also Q 195.)

In addition, in another example: D created an unfunded revocable insurance trust under which life income was payable to B for life and the remainder to E and F. B purchased a life insurance policy on D's life designating the trust as beneficiary and paying all the premiums. While B was alive, D died and the insurance proceeds were paid to the trust. B, until the death of D, possessed all the incidents of ownership in the policy, including the right to change the beneficiary. It was held that B made a completed gift for gift tax purposes to E and F on D's death; the value of the gift was the amount of the policy proceeds less the present value of B's life estate determined by use of the Estate and Gift Tax Valuation Table at Appendix C.[4]

Community Property

210. Does a taxable gift occur when a donor spouse assigns community property life insurance to a donee spouse?

Generally, no. The assignment qualifies for the unlimited marital gift tax deduction applicable to interspousal gifts, even though the policy is community property.[5] (The assignment is actually of the donor spouse's one-half community property interest, because the donee spouse already owns the other one-half.) An annual exclusion may be allowed instead of the marital deduction if the donee spouse is a non-U.S. citizen.

1. See *Goodman v. Comm.*, 156 F.2d 218 (2d Cir. 1946).
2. Rev. Rul. 73-207, 1973-1 CB 409.
3. Rev. Rul. 77-48, 1977-1 CB 292; *Est. of Goldstone v. Comm.*, 78 TC 1143 (1982).
4. Rev. Rul. 81-166, 1981-1 CB 477.
5. IRC Sec. 2523.

211. If one spouse uses community property to purchase life insurance on either spouse's life and names a child as beneficiary, does the death of the insured spouse give rise to a taxable gift from the noninsured spouse?

Perhaps. If under state law the insured spouse's death makes the transfer of the noninsured spouse's community interest absolute, a gift will be imputed to the noninsured spouse of half the amount of the proceeds of such insurance payable to the child (the result would be the same for any third party).[1] This result has been followed under Texas and Louisiana law.[2]

In Louisiana, life insurance owned by one spouse either may be separate or community property even if community property is used to purchase the policy. As a result, a noninsured spouse could be treated as making a gift of all or one-half of the proceeds when the insured spouse dies and proceeds are paid to the child.[3] When the noninsured spouse, as beneficiary, receives his or her community share or more, no gift is imputed to the noninsured spouse of amounts also payable to a third-party beneficiary unless there is evidence of donative intent.[4]

Death-Benefit-Only Plans

212. Are death-benefit-only (DBO) plans subject to gift tax?

No, at least not at the time of death. Revenue Ruling 92-68[5] revoked Revenue Ruling 81-31,[6] in which the IRS treated an employee as making a gift of the benefit from a DBO plan in the year of the employee's death.[7] Note that neither Revenue Ruling 81-31 nor *Est. of DiMarco v. Comm*. addressed whether an employee should be treated each year as (1) receiving compensation equal to the value of providing a death benefit or survivor income benefit to an eligible survivor if the employee died during the year, and (2) transferring such value to the eligible survivor. The use of the annual exclusion and the marital deduction might protect such a gift from any gift tax. (See Q 96 for estate tax aspects).

Gift Tax Annual Exclusion

213. May the annual exclusion of $14,000 for gifts to each donee be applied against gifts of life insurance policies and premiums?

Yes, if the gifts are made in such manner that they are gifts of present interests.

The annual exclusion of $14,000 (in 2013, up from $13,000 in 2011 and 2012, see Appendix D) is not available for gifts of future interests (Q 214). If the gift of the policy is a gift of a present interest, premiums subsequently paid by the donor also will qualify for the exclusion (Q 218). The annual exclusion is effectively $28,000 in 2013 (2 × $14,000, see Appendix D) if the donor

1. Treas. Reg. §25.2511-1(h)(9).
2. Rev. Rul. 48, 1953-1 CB 392 (La.); Rev. Rul. 232, 1953-2 CB 268 (Texas); *Comm. v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958).
3. See Rev. Rul. 94-69, 1994-2 CB 241, revoking Rev. Rul. 48, above; Rev. Rul. 232, above; Rev. Rul. 2003-40, 2003-17 IRB 813.
4. *Kaufman v. U.S.*, 462 F.2d 439 (5th Cir. 1972).
5. Rev. Rul. 92-68,1992-2 CB 257, revoking Rev. Rul. 81-31, below.
6. Rev. Rul. 81-31, 1981-1 CB 475.
7. *Est. of DiMarco v. Comm.*, 87 TC 653 (1986), acq. in result, 1990-2 CB 1.

makes a gift to a third party with the consent of his or her spouse (Q 112). For gifts from one spouse to another, see Q 109.[1]

> *Example*. Donor, a widower, assigns a policy on his life to his son in 2013. The policy's value is $14,000. The gift tax annual exclusion of $14,000 (in 2013, see Appendix D) can be applied against the gift of the policy. The donor may continue to pay the annual premium of $1,500 in subsequent years and need not report the premium payments for gift tax purposes so long as they fall within the gift tax annual exclusion for such subsequent year (unless he gives his son other gifts in any one year that together with the premium payments exceed the annual exclusion for such year).

When the value of a policy exceeds the annual exclusion, the insurance company may consent to split it into two or more smaller policies. By giving the donee one policy in each of several succeeding years, the entire value can fall within the annual exclusions. In some instances, however, such a split would result in a higher premium.

214. When is the gift of a life insurance policy considered the gift of a future interest that deprives the donor of the gift tax annual exclusion?

A future interest is created when restrictions are placed upon the donee's right to receive benefits or to exercise ownership rights under the policy. The gift of a policy is not considered a gift of a future interest merely because the obligations under the contract are payable at some time in the future. However, a future interest in these contractual obligations can be created by limitations contained in a trust or other instrument of transfer used in effecting a gift (Q 154).[2] (But see Q 155 for gifts in trust to minors.) A gift of a policy to a corporation is a gift of a future interest to its shareholders.[3] In one case, gifts made to individual partnership capital accounts were treated as gifts of a present interest that qualified for the gift tax annual exclusion because the partners were free to make immediate withdrawals of the gifts from their capital accounts.[4]

215. Is the annual exclusion available when an insured transfers ownership of a life insurance policy to two or more donees jointly?

No. If joint action is required to exercise ownership rights in the policy, it is a gift of a future interest.[5]

Planning Point: If gifts of premiums are subsequently made by the donor they should be made separately to each donee and the donees may then pay the premiums to the insurance company. That way the gifts of premiums will qualify for the annual gift tax exclusion.

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216. Will the gift of a life insurance policy fail to qualify for the annual exclusion merely because the policy has no cash value?

No.[6]

1. IRC Sec. 2503(b), Treas. Regs. §§25.2503-3(a), 25.2503-3(c)(Ex. 6).
2. Treas. Reg. §25.2503-3.
3. Rev. Rul. 71-443, 1971-2 CB 337.
4. *Wooley v. U.S.*, 90-1 USTC ¶60,013 (S.D. Ind. 1990).
5. *Skouras v. Comm.*, 188 F.2d 831 (2nd Cir. 1951).
6. Rev. Rul. 55-408, 1955-1 CB 113.

217. Does the outright gift of a life insurance policy qualify for the gift tax annual exclusion, even if the gift is to a minor?

Yes.

The exclusion can be applied against the value of the policy at the time of the gift and to subsequent premium payments.[1] An outright gift of a policy to a minor qualifies for the exclusion even though a guardian is not appointed.[2] A gift of life insurance under a Uniform Gifts to Minors Act or a Uniform Transfers to Minors Act generally qualifies for the gift tax annual exclusion. All but a few states have modified the Uniform Act to include gifts of life insurance. Any transfer of property to a minor under statutes patterned after either the model act or the uniform act constitutes a complete gift for federal gift tax purposes to the extent of the full fair market value of the property transferred. Such a gift generally qualifies for the gift tax annual exclusion authorized by IRC Section 2503(b).[3] If the subject of the gift is life insurance, its "full fair market value" would presumably be established by the same rules applicable to gifts of life insurance generally (Q 114).

218. When a life insurance policy has been given away, are premiums subsequently paid by the donor gifts of a present interest qualifying for the annual exclusion or are they a future interest?

The payment of premiums is a gift of a present interest if the gift of the policy was a present interest gift. Likewise, the premium is a future interest gift if the gift of the policy was a future interest gift (Q 207).[4]

Gifts Within Three Years of Death

219. If an insured, within three years of his or her death, makes a gift of life insurance on which the insured pays a gift tax, is the gift also subject to estate tax?

Both the insurance proceeds and the gift tax paid will be included in the gross estate.[5]

Disability Provisions Under Life Policies

220. Are premiums paid for disability provisions under a life insurance policy deductible as medical expenses?

No.[6]

1. IRC Sec. 2503(b); Treas. Regs. §§25.2503-3(c)(Ex. 6), 25.2511-1(a), 25.2511-1(g).
2. *Baer v. Comm.*, 2 TCM (CCH) 285 (1943), aff'd 149 F.2d 637 (8th Cir. 1945); Rev. Rul. 54-400, 1954-2 CB 319; see *Daniels v. Comm.*, 10 TCM (CCH) 147 (1951).
3. Rev. Rul. 56-86, 1956-1 CB 449; Rev. Rul. 59-357, 1959-2 CB 212; Rev. Rul. 73-287, 1973-2 CB 321.
4. *Baer v. Comm.*, ¶43,294 P-H TC Memo (1943), aff'd 149 F.2d 637 (8th Cir. 1945); *Roberts v. Comm.*, 2 TC 679 (1943); *Comm. v. Boeing*, 123 F.2d 86 (9th Cir. 1941); *Bolton v. Comm.*, 1 TC 717 (1943).
5. IRC Sec. 2035.
6. IRC Sec. 213(d)(1).

221. Is disability income payable under the provisions of a personal life insurance policy included in gross income?

No. Benefits received under a disability rider are tax-exempt as "amounts received through accident or health insurance … for personal injuries or sickness." There is no limit on the amount of disability income that can be received tax-free.[1] Benefits are exempt whether received by the insured, or by a person or corporation having an insurable interest in the insured.[2]

222. Are life insurance premiums that have been waived because of the insured's disability taxable income to the insured?

No. When waived, the premiums are exempt as "amounts received through accident or health insurance … for personal injuries or sickness."[3] However, the Tax Court seems to have indicated that they are not constructively received by the insured. Although not directly addressed in the case, apparently the waived premiums would also not be taxable to the insured since they were not constructively received by the insured.[4]

Note that because premiums paid for a supplementary benefit such as a waiver of a premium must be excluded from premium cost (Q 456), a policy on which premiums have been waived for a period of years would have a lower cost basis than a similar policy where the taxpayer paid the premiums.

223. If a corporation attaches a disability income rider to a key person life insurance policy, what are the tax consequences to the corporation and to the key person?

Where the employee is a designated payee of the disability income, the tax consequences are uncertain. However, it would seem that the disability rider should be treated as accident and health insurance, separable from the life insurance, and that the results would be as follows: the corporation could deduct, as a business expense, the premiums paid for the disability income coverage;[5] the premiums would not be taxable to the key person;[6] and the disability income would be taxable to the key person.[7] A tax credit may be available to the key person.

If the disability income is payable to the corporation, the corporation cannot deduct the premium payments,[8] but the disability income is tax-exempt to the corporation.[9] If the corporation uses the disability income to make disability retirement payments to the key person, it would seem that the corporation could deduct the payments as a compensation expense. The payments would be taxable to the key person,[10] but the key person might be eligible for a tax credit.

1. IRC Sec. 104(a)(3).
2. *Castner Garage, Ltd. v. Comm.*, 43 BTA 1 (1940), acq.
3. IRC Sec. 104(a)(3).
4. *Est. of Wong Wing Non v. Comm.*, 18 TC 205 (1952).
5. IRC Sec. 162(a).
6. IRC Sec. 106(a).
7. IRC Sec. 104(a)(3).
8. IRC Sec. 265(a)(1).
9. IRC Sec. 104(a)(3); *Castner Garage, Ltd. v. Comm.*, 43 BTA 1 (1940), acq.; *Rugby Prod. Ltd. v. Comm.*, 100 TC 531 (1993); Rev. Rul. 66-262, 1966-2 CB 105.
10. IRC Sec. 104(a)(3).