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Internal Revenue Service
UIL No. 0101.01-02
Number: **199903020**
Release Date: 1/22/1999

LEGEND:

CC:DOM:FI&P:4/PLR-110154-98
PLR-110156-98
PLR-110157-98
October 26, 1998

S1 =

S2 =

S3 =

H =

m =

n =

p =

Partnership =

W =

Date RR =

Date 1 =

Date 2 =

Date 3 =

Policy =

R =

State =

State Statute =

Trust HWI =

Trust HWR =

Trust 1 =

Trust 2 =

x =

y =

z =

Dear :

This is in response to the letter dated Date RR and additional submissions on behalf of S1, S2, and S3 ("Taxpayers") requesting a ruling that the proposed transaction will satisfy the requirements of § 101(a)(2)(B) of the Internal Revenue Code, and therefore, will not affect the application of § 101(a)(1) to policy proceeds that Taxpayers will receive pursuant to a life insurance purchase agreement relating to a second-to-die policy.

FACTS

Trust HWI is an irrevocable life insurance trust that was established by H and W, husband and wife, on Date 1 for the benefit of S1, S2, and S3, their children; their grandchildren; and other issue. S1 and S2 are the trustees of Trust HWI. By its terms, the validity and construction of Trust HWI is governed by the laws of State. Taxpayers represent that no person is treated as the owner of any portion of Trust HWI under the provisions of §§ 671-79 of the Code.

Trust HWI owns, and is the designated beneficiary of Policy, a modified whole

life second-to-die policy on the lives of H and W. The face amount of Policy is \$x. Additionally, Policy contains a rider providing for an adjustable benefit payable on the death of the second insured to die. Under Policy, the amount payable upon the death of the second insured to die is the sum of \$x and an adjustable insurance amount specified by the rider (\$y at the time Policy was issued), adjusted for policy debt, dividend credits, and premiums in default or paid (other than by a waiver benefit, if any) past the date of death of the second insured to die. The cash surrender value of Policy as of Date 2² was \$z.

Taxpayers represent that Partnership is a State general partnership that was in existence prior to January 1, 1997. Taxpayers represent that Partnership has filed its federal income tax returns as a partnership for all tax years that it has been in existence. Taxpayers further represent that, through the year in which the proposed transaction is consummated, Partnership will not elect to be treated as other than a partnership under § 301.7701-3(c) of the Procedure and Administration Regulations.

Taxpayers represent that the partners in Partnership are Trust HWR, Trust 1, Trust 2, S3, and R. Taxpayers make the following representations concerning the partners of Partnership: (1) H and W are the grantors of Trust HWR, both H and W have the power to revoke Trust HWR, and therefore, both H and W are treated for income tax purposes as the owners of the assets of Trust HWR under § 676 of the Code; (2) S1 is the grantor of Trust 1, S1 has the power to revoke Trust 1, and therefore S1 is treated for income tax purposes as the owner of the assets of Trust 1 under § 676; and (3) S2 and S2's spouse are the grantors of Trust 2, S2 contributed S2's partnership interest in Partnership to Trust 2, S2, under the terms of Trust 2, has an unrestricted right to withdraw any assets that S2 contributed to Trust 2, and therefore, under § 676, S2 is treated for income tax purposes as the owner of the partnership interest in Partnership that S2 contributed to Trust 2. Taxpayers also represent that Partnership and Taxpayers use the calendar year as their taxable year for federal income tax purposes.

Additionally, as of Date RR, Taxpayers represent that Trust HWR, Trust 1, Trust 2, and S3 hold interests in Partnership, both capital and income, equal to or greater than m percent. Taxpayers further represent that the interests of Trust HWR, Trust 1, Trust 2, and S3 in Partnership will not be reduced, before or during the year the proposed transaction is consummated, below that held by the respective partners on Date RR.

Taxpayers represent that Partnership is an operating real estate partnership that owns and leases a commercial building. Taxpayers further represent that Partnership does not own any life insurance, and will not, before or during the year the proposed transaction, is consummated.

² Date 2 is less than a month prior to Date RR.

Trust HWI has paid the premiums of Policy through Date RR as a result of H and W making additional gifts to Trust HWI. Taxpayers represent that H and W no longer intend to make such gifts, and that without such gifts, Trust HWI will be unable to pay Policy's premiums.

Taxpayers represent that they are willing to assume the obligation of paying Policy's premiums, beginning with the next premium payment due on Date 3. They state that by assuming this obligation Policy will remain in force, "so that the benefit of [its] indemnity . . . will not be lost to [Taxpayers] and [Trust HWI]." Taxpayers further represent that, in addition to Partnership, they are involved in n real estate investment partnerships with H and W. Taxpayers state that on the death of the survivor of H and W, Trust HWI and Taxpayers will require the "liquidity of insurance proceeds to purchase, loan or take such other action as may be necessary to preserve the various fractional and illiquid partnership interests formerly held by the decedents [and] [i]n this way, liquidation, partition and/or business interruptions of one or more of the partnerships can be avoided."

The proposed transaction consists of Taxpayers and Trust HWI entering into a life insurance purchase agreement ("LIPA") that is designed to maintain Policy in force for the benefit of Taxpayers and Trust HWI. Taxpayers represent that, under the terms of Trust HWI and State Statute, S1 and S2, the trustees of Trust HWI, are authorized to enter into LIPA.

LIPA provides that in consideration of the payment of \$p (a nominal amount) and Taxpayers' obligation to timely pay all future premiums due under Policy, Trust HWI will sell Taxpayers an interest in Policy. Specifically, upon the death of the second insured to die, the insurance proceeds of Policy will be divided proportionately between Trust HWI and Taxpayers in the ratio that Policy's cash surrender value as of Date 2 bears to the cash surrender value on the day immediately preceding the death of the surviving insured.³

Other terms of LIPA provide that Trust HWI and Taxpayers will be joint owners of Policy, and may, in general, jointly exercise all ownership rights under the terms of Policy. Any dividends declared on Policy, or other increase in Policy's cash surrender value or death benefits, will be divided between Trust HWI and Taxpayers proportionately according to the ratio that Policy's cash surrender value on Date 2 bears to Policy's cash surrender value on the day immediately prior to the day the dividend is declared, the cash value is increased, or the death benefit is increased. If Policy is

³ For example, assume Policy's cash surrender value on Date 2 is w, its cash surrender value on the day immediately preceding the death of the surviving insured is 1.5w, and that U is the amount payable upon the death of the surviving insured. Then, under LIPA, Trust HWI's share of Policy's proceeds would be (2/3)U, while Taxpayers' share would be (1/3)U.

surrendered prior to the death of the surviving insured, the cash surrender value will be divided between Trust HWI and Taxpayers in the ratio that Policy's cash surrender value on Date 2 bears to Policy's cash surrender value on the day immediately preceding the surrender. Trust HWI and Taxpayers agree not to take any action with respect to Policy that would in any way compromise or jeopardize either Trust HWI's or Taxpayers' proportionate share of Policy's cash surrender value. Also, Trust HWI and Taxpayers further agree not to change Policy's beneficiary designation provisions so as to impair the rights of either party to receive the payments called for in LIPA.

LAW AND ANALYSIS

Section 101(a)(1) of the Code provides that, except as otherwise provided in § 101(a)(2), 101(d), and 101(f), gross income does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured.

Section 101(a)(2) of the Code provides, generally, that if a life insurance contract, or any interest therein, is transferred for a valuable consideration, the exclusion from gross income provided by § 101(a)(1) is limited to an amount equal to the sum of the actual value of the consideration and the premiums and other amounts subsequently paid by the transferee.

An exception to the general rule of § 101(a)(2) of the Code is provided in § 101(a)(2)(B) when the life insurance contract is transferred to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. In these cases, the general rule of § 101(a)(2) will not affect the application of § 101(a)(1) to amounts received by the beneficiaries.

The term "transfer for a valuable consideration" is defined, for purposes of § 101(a)(2) of the Code, in § 1.101-1(b)(4) of the Income Tax Regulations as any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Section 1.101-1(b)(4) further provides that the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for a valuable consideration of the policy or an interest thereof. On the other hand, § 1.101-1(b)(4) states that the pledging or assignment of a policy as collateral security is not a transfer for a valuable consideration of such policy or interest therein, and § 101 of the Code is not applicable to amounts received by the pledgee or assignee.

With an exception not here relevant, under § 301.7701-3(b)(3)(i) of the Procedure and Administration Regulations, unless it elects otherwise, an eligible entity,⁴ in

⁴ An "eligible entity" is defined in § 301.7701-3(a) as a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), and (8).

existence prior to January 1, 1997, will have the same classification that the entity claimed under §§ 301.7701-1 through 301.7701-3, as in effect prior to January 1, 1997.

LIPA gives Taxpayers the right to receive a portion of the proceeds of Policy. LIPA is not a gratuitous transfer to Taxpayers by Trust HWI. Taxpayers have agreed to pay Trust HWI \$p and to pay all of Policy's future premiums. If Trust HWI were forced to surrender Policy because of H's and W's decision to stop paying premiums, Trust HWI would generally receive only Policy's cash surrender value, which was \$z on Date 2.⁵ LIPA affords Trust HWI the opportunity to receive a greater amount at the death of the second of the insureds. In other words, because of Taxpayers' premium payments, Trust HWI will continue to have insurance protection on the lives of H and W, albeit in an amount that decreases as the proportion of premiums paid by Taxpayers increases.

Monroe v. Patterson, 197 F. Supp. 146 (N.D. Ala. 1961), also supports treating Taxpayers' obligation to pay Policy's premiums as providing value to Trust HWI for entering into LIPA. The plaintiffs in Monroe, shareholders in a corporation, entered into an agreement with two other shareholders of the corporation concerning two policies on the life of one of the two other shareholders. Under the agreement, plaintiffs agreed to pay two-thirds of the policies' premiums, and, upon the death of the insured, to purchase the shares of the insured and the other shareholder at a price set by the agreement. The agreement further provided that the insurance policies were to be assigned to two trustees who would pay the proceeds upon the insured's death to the insured's estate and to the other selling shareholder as all, or, a portion of, the agreed-upon purchase price of the stock. The court found that the proceeds of the policies were constructively received by the plaintiffs in exchange for a valuable consideration, the payment of the premiums and the plaintiffs' obligation to purchase the stock of the insured and the other shareholder. Accordingly, the court held that the limitation of § 101(a)(2) of the Code applied, and that the plaintiffs were required to include in their gross incomes the amount of insurance proceeds they constructively received in excess of premiums paid.

We conclude that, under LIPA, there will be an absolute transfer for value to Taxpayers of a right to receive all or a part of the proceeds of Policy. For purposes of § 101(a)(2) of the Code, Trust HWI will have transferred an interest in Policy to Taxpayers for a valuable consideration.

Under Taxpayers' representations, Partnership is a partnership for federal tax purposes, and will remain such through the year in which the proposed transaction is consummated. Further, Taxpayers have represented that Taxpayers and both of the insureds, H and W, are treated as partners in Partnership for federal income tax purposes, and will continue to be so treated through the year in which the proposed

Partnership is an eligible entity.

⁵An option to receive reduced paid-up insurance is also available under Policy.

transaction is consummated. Thus, the proposed transaction satisfies the requirements of § 101(a)(2)(B) of the Code, and the general rule of § 101(a)(2) will not affect the application of § 101(a)(1) to that portion of Policy's proceeds that the Taxpayers will receive under LIPA upon the death of the survivor of H and W.

CONCLUSION

The general rule of § 101(a)(2) will not affect the application of § 101(a)(1) to that portion of the proceeds of Policy payable to Taxpayers under the proposed life insurance purchase agreement.

CAVEATS

1. Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the proposed transaction under any other provision of the Code or regulations.
2. Specifically, no opinion is expressed concerning whether Policy qualifies as a "life insurance contract," as that term is defined in § 7702(a) of the Code.
3. Specifically, no opinion is expressed concerning the correctness of Taxpayers' representation that under the terms of Trust HWI and State Statute, the trustees of Trust HWI are authorized to enter into the proposed transaction.
4. Specifically, no opinion is expressed regarding the federal gift tax consequences arising from Taxpayers' payment of Policy's premiums pursuant to the terms of LIPA.

The rulings contained in this letter are based upon information and representations submitted by the taxpayers and accompanied by penalty of perjury statements executed by the taxpayers. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

A copy of this letter must be attached to any income tax return to which it is relevant.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
Assistant Chief Counsel
(Financial Institutions and Products)

By: _____

CC:DOM:FI&P:4-PLR-110154-98

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Donald J. Drees, Jr.
Senior Technician Reviewer
Branch 4

Enclosure

Copy for section 6110 purposes

cc: