INTERNAL REVENUE SERVICE

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February 2, 2001

LEGEND:

a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
Bank	=
Trust 1	=
Trust 2	=
Trust 3	=
Trust 4	=
Trust 5	=
State 1	=
D1	=
D2	=
D3	=
T	=

H	=
W	=
Corp	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
LLC	=
Policy X1	=
Policy X2	=
Policy Y1	=
Policy Y2	=

This is in response to your letter dated Date 1, and additional submissions on behalf of Trust 1, H, W (H’s spouse), and Trust 5 (referred to collectively as “Taxpayers”), requesting rulings concerning the income and generation-skipping transfer tax consequences of proposed transfers of policies insuring the lives of H and W.

FACTS

On Date 2, H created Trust 1. The trustees of Trust 1 are D1, one of H’s children, and T, an unrelated party. During D1's lifetime, D1 is the sole beneficiary of Trust 1. At D1's death, D1 may appoint by will, or other written instrument, the balance of the trust principal and undistributed income to or among H’s issue, except that D1 may not appoint to D1, D1's estate, D1's creditors, or to creditors of D1's estate.

The Trust 1 trust instrument authorizes the trustees of Trust 1 to purchase contracts of insurance on the lives of H and W, or on both lives. The assets of Trust 1 consist of two second-to-die policies insuring the lives of H and W, Policy X1 and Policy Y1 (to be described more fully below), and a minimal amount of cash. Taxpayers represent that under § 677(a)(3) of the Internal Revenue Code, H, the grantor, is treated as the owner of Trust 1.

On Date 2, H also created Trust 2. The trustees of Trust 1 are D1 and T. In contrast to Trust 1, D1 is not a beneficiary of Trust 2. The trustees of Trust 1 are authorized to make discretionary distributions of income and principal to D2 and D3, the other children of H, and to H's issue other than D1.[1]

The Trust 2 trust instrument authorizes the trustees of Trust 2 to purchase contracts of insurance on the lives of H and W, or on both lives. The assets of Trust 2 consist of two second-to-die policies insuring the lives of H and W, Policy X2 and Policy Y2, and a minimal amount of cash. Taxpayers represent that under § 677(a)(3) of the Code, H, the grantor, is treated as the owner of Trust 2.

Trust 1 and Trust 2 were respectively the original purchasers of Policy X1 and Policy X2 (the "X Policies"), and have paid all premiums on these policies. Each of the X Policies has a face value of $a. As of Date 1, each X policy had an interpolated terminal reserve value of $b.

Policy Y1 and Policy Y2 (the "Y Policies") are subject to split-dollar arrangements with Corp.[2] Both Trust 1 and Trust 2 were the original acquirers of their interests in the Y Policies. Under the split-dollar arrangements, Trust 1 and Trust 2 pay the portion of the premium relating to term insurance protection; premiums in excess of this amount are paid by Corp. Upon the death of the last surviving insured, Corp is entitled to receive from the policy proceeds the amount of premiums it paid under the split-dollar arrangement less any outstanding indebtedness (including interest) it owes to the insurance company ("split-dollar amount"). The balance is payable to the beneficiaries designated by Trust 1 or Trust 2. The split-dollar arrangements are binding on the successors and assigns of the contracting parties.

The face value of each of the Y Policies is $c. As of Date 1, each Y Policy had an interpolated terminal reserve value of $d. As of Date 1, the split-dollar amount for each Y Policy was $e.

On Date 3, H created Trust 3. T and Bank are the trustees of Trust 3. D1, D2, and D3 are all beneficiaries of Trust 3. Taxpayers represent that Trust 3 is treated as a grantor trust, owned by H for federal income tax purposes, and that H's federal income tax return is consistent with this representation.

On Date 3, W created Trust 4. T and Bank are the trustees of Trust 4. D1, D2, and D3 are all beneficiaries of Trust 4. Taxpayers represent that Trust 4 is treated as a grantor trust, owned by W for federal income tax purposes, and that W's federal income

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[1] As long as D1 is serving as a trustee, D1 has sole authority to make all decisions concerning discretionary distributions of income and principal. The trust instrument provides that no trust distribution is to be made that would relieve D1 or D1's spouse from their obligations to support and maintain D1's children.

[2] Taxpayers represent that H and W are employees of Corp, actively engaged in Corp's business, and in good health. They are also direct stockholders of Corp and own interests in Corp indirectly, as set forth in more detail in the text and footnote 3, below.

tax return is consistent with this representation.

On Date 4, H and W created Trust 5. T and D1 are the trustees of Trust 5. D1, D2, and D3 are all beneficiaries of Trust 5. The assets of Trust 5 consist of $f in cash and a g% interest in LLC, a State 1 limited liability company. Taxpayers represent that Trust 5 is not, for federal income tax purposes, treated as owned by the grantors or other persons.

LLC was formed on Date 3. Taxpayers represent that LLC was created in order to consolidate the ownership of the nonvoting stock of Corp into one entity.[3] LLC's original members were H, who owned h% of LLC; W, who owned i% of LLC; and Trust 5, which owned g% of LLC. LLC has never filed Form 8832, Entity Classification Election, to be treated as a corporation for federal tax purposes. It has filed all of its federal tax returns as a partnership.

On Date 5, H transferred (h-1.0)% of H's interest in LLC to Trust 3. Also on Date 5, W transferred (i-1.0)% of W's interest in LLC to Trust 4. Currently, the members of LLC are H, W, Trust 3, Trust 4, and Trust 5, with their ownership percentages unchanged since the Date 5 assignments.

At the present time, Trust 1 owns Policy X1 and Policy Y1; while Trust 2 owns Policy X2 and Policy Y2. Trust 1 primarily benefits D1; while Trust 2 benefits D2 and D3 to the exclusion of D1. D1, D2, and D3 are all beneficiaries of Trust 3, Trust 4, and Trust 5. Taxpayers represent that, for the purpose of dividing the insurance proceeds from the X and Y Policies equally among D1, D2, and D3, the trustees of Trusts 1 and Trust 2 propose the following transactions:

1. Trust 1 and Trust 2 will borrow sufficient amounts from their respective X Policies to enable Trust 5 to purchase the X Policies with the cash available to Trust 5. (See paragraphs 2 and 3 below regarding the purchase price of the X Policies.)

2. Trust 1 will transfer Policy X1 to Trust 5 for cash consideration equal to the sum of the interpolated terminal reserve value of Policy X1 on the date of the proposed transfer and the proportionate amount of the premium last paid before the date of the proposed transfer that covers the period extending beyond the date of the proposed transfer less any outstanding indebtedness on the contract at the date of transfer ("Reg Value")[4].

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[3] LLC owns substantially all of the nonvoting stock (common and preferred) of Corp. H and W each own 50% of the only class of voting stock (preferred) of Corp.

[4] In general, this is the value for federal gift tax purposes of a life insurance contract which has been in force for some time and on which further premium payments are to be made, and on which there are no accrued dividends. See § 25.2512-6(a) of the Gift Tax Regulations, set forth in more detail in the text below.

3. Trust 2 will transfer Policy X2 to Trust 5 for cash consideration equal to Policy X2's Reg Value at the time of the transfer.

4. Trust 1 will transfer its interest in Policy Y1 to Trust 3 for cash consideration equal to Policy Y1's Reg Value at the time of the transfer less Policy Y1's split-dollar amount at the time of the transfer.

5. Trust 2 will transfer its interest in Policy Y2 to Trust 4 for cash consideration equal to Policy Y2's Reg Value less Policy Y2's split-dollar amount at the time of the transfer.[5]

LAW AND ANALYSIS

Section 761(a) of the Internal Revenue Code provides, in part, that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate. Section 1.761-1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3 of the Procedure and Administration Regulations.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an "eligible entity") can elect its classification for federal tax purposes. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership. Section 301.7701-3(b)(1) provides that a domestic eligible entity, unless it elects otherwise, will be a partnership if it has two or more members.

Section 761(b) of the Code and § 1.761-1(b) of the Income Tax Regulations provide that for purposes of Subtitle A of the Code, the term "partner" means a member of a partnership.

Section 1.671-3(a)(1) of the regulations provides, in part, that if a grantor is treated as the owner of an entire trust, the grantor takes into account in computing the grantor's income tax liability all items of income, deduction, and credit to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as the owner.

Rev. Rul. 85-13, 1985-1 C.B. 184, concludes that if a grantor is treated as the owner of the entire trust, the grantor is considered to be the owner of the trust assets

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[5] Note that in each transfer the transferee will acquire the transferred policy subject to outstanding policy indebtedness and the transferor will retain no liability for such indebtedness.

for federal income tax purposes.

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.

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 regulations as any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy.

An exception to the general rule of § 101(a)(2) is provided in § 101(a)(2)(B) when a 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.

Section 1041(a)(1) of the Code provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse.

Section 1041(b) of the Code provides that in case of any transfer of property described in § 1041(a) –

> (1) for purposes of Subtitle A of the Code, the property shall be treated as acquired by the transferee by gift, and
>
> (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

Section 2501(a)(1) of the Code imposes a gift tax on the transfer of property by gift. Section 2511(a) provides that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2512-6(a) of the Gift Tax Regulations provides that the value of a life insurance contract or a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or though the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.

Section 2601 of the Code imposes a tax on every generation-skipping transfer.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the “Act”) and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the generation-skipping transfer tax shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(ii)(A) of the regulations provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in § 26.2601-1(b)(ii)(B) or (C), which relates to property includible in a grantor’s gross estate under §§ 2038 and 2042 of the Code.

Section 26.2601-1(b)(1)(iv)(A) of the regulations provides that, if an addition is made after September 25, 1985, to an irrevocable trust that is otherwise exempted from the application of the generation-skipping transfer tax by reason of § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1) of the regulations, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the generation-skipping transfer tax provisions.

Partnership Ruling

Taxpayers have requested a ruling that H, W, and Trust 5 will be treated as partners by virtue of their membership in LLC.

Because LLC has not elected to be treated as an association for federal tax purposes, it will be treated as a partnership under § 301.7701-3(b) of the regulations. Because Trust 3 is treated as a grantor trust owned by H, H is treated as the owner of the membership interest in LLC held by Trust 3. Similarly, because Trust 4 is treated as a grantor trust owned by W, W is treated as the owner of the membership interest in LLC held by Trust 4. Accordingly, based on the facts and representations provided, we rule that H, W, and Trust 5 will be treated as partners in LLC.

Transfer-for Value Rulings

The proposed transfers by Trust 1 and Trust 2 of the X Policies to Trust 5 will be "transfers for a valuable consideration" as defined in § 1.101-1(b)(4) of the regulations. Trust 5, the transferee, will be a partner of both the insureds under the X Policies (H and W) by virtue of their membership in LLC at the time of the proposed transfers. Thus, the proposed transfers of the X Policies to Trust 5 will satisfy the requirements of § 101(a)(2)(B) of the Code, and will not affect the application of § 101(a)(1) to amounts that the beneficiaries of the X Policies will receive under these contracts upon the deaths of H and W.

Taxpayers represent that both Trust 1 and Trust 3 are for federal income tax purposes treated as grantor trusts owned by H. Thus, H is treated for federal income tax purposes as the owner of all of the assets of Trust 1 and Trust 3. See Rev. Rul. 85-13. Therefore, the "transfer" of Trust 1's interest in Policy Y1 to Trust 3 is disregarded for federal income tax purposes, and will not affect the application of § 101(a)(1) of the Code to amounts that the beneficiaries of Policy Y1 will receive upon the deaths of H and W.

The proposed transfer of Trust 2's interest in Policy Y2 to Trust 4 is not ignored, for federal income tax purpose, since Taxpayers represent that, for federal income tax purposes, Trust 2 is a grantor trust owned by H and Trust 4 is a grantor trust owned by W. Thus, H is treated as transferring H's interest in Policy Y2 to W. See Rev. Rul. 85-13. Under § 1041(b)(1) of the Code, W, for federal income tax purposes, is treated as acquiring W's interest in Policy Y2 by gift, and not for value. Therefore, the "transfer-for-value" rule of § 101(a)(2) does not apply to the transfer of Trust 2's interest in Policy Y2 to Trust 4. Accordingly, the transfer of Trust 2's interest in Policy Y2 to Trust 4, will not affect the application of § 101(a)(1) of the Code to amounts that the beneficiaries of Policy Y2 will receive upon the deaths of H and W.

Generation-Skipping Transfer Tax Provisions

Trust 5 is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 of the Code apply. Taxpayers propose that Trust 5 will purchase each X policy for its interpolated terminal reserve value with proper adjustments for the last premium payments and outstanding indebtedness. Accordingly, Trust 5 will be considered to pay full value for the X policies. As such, neither the investment in the policies nor the death benefit payable on the death of the last to die of H or W will represent additions to Trust 5 within the meaning of § 26.2601-1(b)(iv) of the regulations.

CONCLUSIONS

1. LLC will be treated as a partnership for federal tax purposes. H, W, and Trust 5 will be treated as partners in LLC for federal tax purposes.

2. The proposed transfer of Policy X1 by Trust 1 and Policy X2 by Trust 2 will satisfy the requirements of § 101(a)(2)(B) of the Code, and will not affect the application of § 101(a)(1) to amounts that the beneficiaries of those contracts will receive upon the deaths of H and W.

3. The “transfer” of Trust 1's interest in Policy Y1 to Trust 3 is disregarded for federal income tax purposes, and will not affect the application of § 101(a)(1) of the Code to amounts that the beneficiaries of Policy Y1 will receive upon the deaths of H and W.

4. The transfer of Trust 2's interest in Policy Y2 to Trust 4 is treated for federal income tax purposes as a gratuitous transfer, which will not affect the application of § 101(a)(1) of the Code to amounts that the beneficiaries of Policy Y2 will receive upon the deaths of H and W.

5. Neither Trust 5's investment in the X policies nor the death benefit payable on the death of the last to die of H or W will represent additions to Trust 5 within the meaning of § 26.2601-1(b)(iv) of the regulations.

CAVEATS

1. Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the proposed transactions under any other provision of the Code or regulations.

2. Specifically, no opinion is expressed or implied concerning whether the X and Y Policies are "life insurance contracts," as defined in § 7702(a) of the Code.

3. Specifically, no opinion is expressed or implied concerning whether H, W, or any other person is required to be treated as the owner of any portion of Trusts 1, 2, 3, 4, or 5 under subpart E of subchapter J of Chapter 1 of the Code (§§ 671-679).

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 federal 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,
Acting Associate Chief Counsel
(Financial Institutions and Products)
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Senior Technician Reviewer
Branch 4