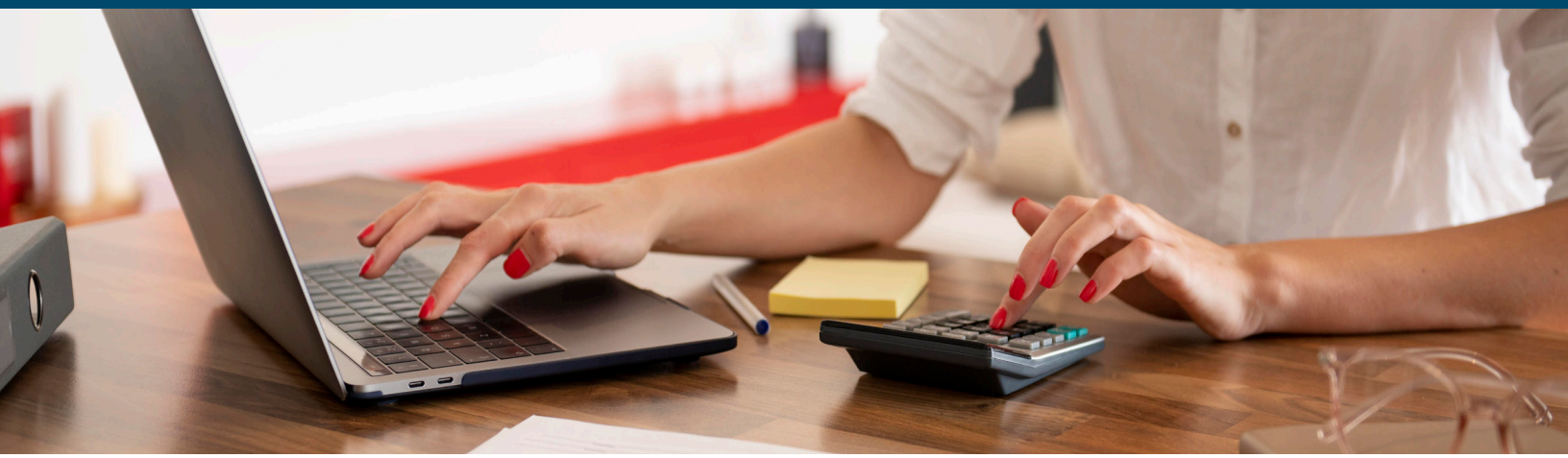

How Can I Avoid the Three-Year Rule on the Transfer of a Policy?

Situation: I'm often confronted with the situation where an individual has purchased a policy on his or her life and retained an "incident of ownership" causing the proceeds to be included in his or her taxable estate. To avoid estate inclusion the insured may seek to transfer the policy to an ILIT. Unfortunately, certain transfers of life insurance within three-years of an insured's death continue to be included in an insured estate and are subject to estate tax.

This has caused advisors to ask, "Are there strategies for avoiding or minimizing the application of the three-year rule in the situation where an insured wants to transfer a policy, he or she owns to a life insurance trust or third party?" This *Counselor's Corner* describes strategies to undo this error.

Solution: Before we identify strategies to undo or minimize application of the three-year rule, it's first helpful to have a general understanding of when the rule applies.

When Does the Section 2035 Transfer Within Three-Years Rule Apply? Section 2035 originally required that all gifts made within three years of a donor's death be pulled back into his/her gross estate.[1] The Economic Recovery Tax Act of 1981 repealed this all-inclusive version of the three-year pullback rule, replacing it with one that applies to certain narrowly defined transactions. One of the transfers where the three-year rule continues to apply is the transfer of life insurance.

Application of the three-year rule to transfers of life insurance was initially clouded in controversy. Today its application is clear in most situations. The consensus is that Section 2035 requires that life insurance proceeds be included in a decedent's gross estate only where:

- **The policy is on the decedent's life and the decedent had a power or interest in the life insurance within the meaning of Section 2042 (policy is payable to, or for the benefit of, the insured's estate, or the insured had an "incident of ownership" in the policy) at some time during the three-year time period before his or her death;**
- **There was a transfer of an interest in the policy within three years of the decedent's death; and**
- **The transfer was for less than full and adequate consideration in money or money's worth.**

Transfers Not Subject to Section 2035. It's clear that a life insurance policy is includable in a decedent's gross estate under Section 2035 only if the policy would have been included under Section 2042. For Section 2042 to apply the policy must be made payable to, or for the benefit of, the estate, or the decedent must have an "incident of ownership" in a policy on his or her life.[2]

Consequently, the following common transfers are not subject to the three year estate inclusion rule under Section 2035:

- Where a **decedent transfers a policy that he or she owns on the life of another** and dies within three years of the transfer, neither the cash value or death proceeds are included in the decedent's estate.
- Likewise, if **someone other than the decedent/insured owns the policy**, the proceeds are excluded from the insured's estate even if the insured makes a cash gift to the owner who uses the cash to purchase a life insurance policy.
- Of course, where the **decedent/insured outlives the three-year pullback period** and has divested himself/herself of all rights, powers or interests in the policy, none of the proceeds will be includable in his or her gross estate under Section 2035. This is true regardless of whether the insured continued to pay the premiums.[3]

Where an individual possesses an "incidents of ownership" in a policy on his or her life there are basically two alternatives for removing the policy from the estate – to sell the policy or to gift it away. Each strategy has its issues.

Gift of an Existing Life Insurance Policy. If an individual gifts a policy he or she owns on his or her life and continues to pay premiums and dies within three years of the transfer, the full death proceeds will be included in the insured's gross estate. In this situation, it may be possible to exclude a proportionate share of the proceeds included in the insured's gross estate if the donee (the third-party recipient) pays some of the premiums out of his or her own separate funds after the transfer. The portion excluded bears the same relationship to the total policy proceeds as the premiums paid by the donee bears to the total premiums paid.[4] Thus, one strategy to lessen application of the three-year rule is to have the donee pay the premiums from his/her separate funds after the transfer.

Sale of Policy to a Third Party for "Full and Adequate Consideration." The three-year estate inclusion rule does not apply to a "bona fide sale for adequate and full consideration in money or money's worth."[5] This exception presents an opportunity to sell an existing life insurance policy to avoid the three-year rule. However, unless a policy is sold for an amount at least equal to the policy's fair market value, the transaction will fail to meet the "bona fide" sale exception, resulting in estate inclusion under IRC § 2035 if the insured dies within three years. The problem: What constitutes adequate and full consideration?

While the IRS has issued regulations and rulings on the valuation of life insurance, there still remains a great deal of uncertainty as to what measure of value to use in many situations, including transfers subject to the three-year inclusion rule. In addition, the variety of elements that make up an insurance product, the differences in the health of the insured and other circumstances mean the same type of life insurance policy may have different values.

For example, for gift tax purposes, the regulations provide that the value of an unmatured life insurance policy that has been in force for some time and on which premiums are still being paid is the interpolated terminal reserve plus unearned premium.[6] However, it does not necessarily follow that the gift tax regulations will be used when reviewing the adequacy of consideration for the "bona fide sale" exception for estate tax purposes. The IRS's position in private letter rulings has been inconsistent.

In Technical Advice Memoranda (TAM) 8806004 the IRS held that consideration paid for a policy is not adequate for purposes of the three-year rule, unless it is equal to the face amount of the policy. The TAM relied on *United States v. Allen*, which held that the sale of a retained life estate for its gift tax value under the IRS's tables did not constitute adequate and full consideration.[7] Many advisors question whether this retained interest valuation rationale is appropriate when valuing the outright sale of a life insurance policy.

In a more recent letter ruling where a husband and wife created a new trust that purchased joint survivor policies from two pre-existing trusts for an amount equal to the interpolated terminal reserve plus unearned premium, the IRS concluded that the purchase of the policies was for adequate and full consideration and met the bona fide sale exception.[8] Again, in private letter ruling (PLR) 199905010, where a corporation sold a policy it owned on the majority shareholder to the shareholder's children for "the greater of its interpolated terminal reserve value or its cash value," the IRS concluded that the transfer met the adequate and full consideration standard for purposes of the bona fide sale exception. Thus, the most recent position of the IRS appears to acknowledge that the *Allen* rationale is not applicable to the sale of a life insurance policy.

There are other challenges even if the taxpayer manages to avoid the hurdle of "full consideration." First, to accomplish the sale to the trust, the trust must have sufficient funds for the purchase. Where the trust lacks assets, it will need to be seeded through gifts. Where the insured transfers the cash used by the trustee to purchase the policy, the IRS could apply the step transaction rule. Due to the transfer and the subsequent return of the cash used to purchase the policy, the insured is left in the same position the insured would have been in had the policy been transferred to the trust for no consideration. Many advisors believe that to reduce the risk of the application of the step transaction rule, it would be preferable if there were either a substantial time lapse between the transfer of contributions and the subsequent purchase or that someone other than the insured transferred the necessary contributions to the trust.

Second, although transfers for "full and adequate consideration" are except from the three-year pullback rule, transferring a policy for consideration can subject the policy to another tax dilemma, namely, the transfer-for-value rule.

Under IRC § 101, life insurance proceeds are generally exempt from income taxation to the recipient. However, if a policy is transferred in exchange for any form of valuable consideration, the death proceeds in excess of the consideration paid and other amounts subsequently paid by the transferee will be subject to income tax.[9]

Fortunately, there are exceptions to the transfer-for-value rule. It is important to pair the sale to the ILIT with one of these exceptions. The following is a discussion of some of the more common strategies used to reduce the risk that the transfer-for-value rule will be imposed when transferring an existing policy to an ILIT.

Transfer to a Grantor Trust of the Insured. Since a sale to the insured is an exception to the transfer-for-value rule, many advisors believed that a sale of a policy to the insured's grantor trust should qualify as an exception to the transfer-for-value rule. However, until 2007 the only authority that supported this position was *Swanson v. Commissioner* and a series of private letter rulings.[10] In 2007, the IRS issued Revenue Ruling 2007-13, which confirmed that a transfer to a wholly owned grantor trust is the same as a transfer to the insured. The ruling involved two fact patterns.

The first fact pattern involved a transfer of a life insurance policy between two grantor trusts, each of which was treated as being wholly owned by the insured/grantor. The IRS held that a grantor would be treated as the owner of a life insurance policy on his life when the policy is owned by a grantor trust of which the grantor is treated as owner. Consequently, in this situation the IRS held that the transfer-for-value rule did not apply because there was no transfer of ownership.

The second situation involved a transfer from a nongrantor trust to a grantor trust. This transaction was treated as a transfer for valuable consideration. Here, the IRS held that an exception to the transfer-for-value rule applied because the transfer to the grantor trust was deemed to be a transfer to the insured.

Sale to a Trust that is a Partner of the Insured. Using this strategy, the grantor/insured creates an ILIT. The insured then seeds the trust with cash or income producing assets. The ILIT trustee then transfers a portion of the trust's principal in exchange for an interest in a partnership in which the insured is a partner. Next, the ILIT/partner purchases the existing policy from the insured. The new partnership should have more than minimal funding and be operated as a viable partnership with a business purpose and the trust should be more than a nominal partner.

Sale to a Partnership in which the Insured is a Partner. This strategy essentially substitutes the partnership for the ILIT. When using the FLP as an ILIT alternative it takes careful planning to achieve estate tax-free proceeds. The difficulty stems from the lack of regulations dealing with the incidents of ownership held by a partner through a partnership. Furthermore, the IRS has not been consistent in its analysis of the issue. Many advisors believe that in light of the most recent rulings, caution dictates that when structuring within the partnership exception, the policies should represent less than 50% of the partnership assets, the partnership should have an independent business purpose, and the partnership agreement should prohibit a general partner from exercising any power over his or her policy.

In Summary: Clearly, the transfer within three-year rule can present hurdles in situations where an individual has purchased a policy on his or her life and retained ownership causing it to be includable in the gross estate. Fortunately, strategies exist for removing the policy from the insured's estate.

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[1] *Frequently, the three-year rule is referred to as the "contemplation of death" rule. The contemplation of death rule preceded the three-year rule. The contemplation of death rule generally required that all gifts made in contemplation of a donor's death be included in the donor's gross estate. Under this rule, gifts made within three years of a donor's death were presumed to have been made in contemplation of death, but the presumption could be rebutted. The factual nature of the contemplation of death test led to considerable litigation. Consequently, the test was eliminated in 1976 and replaced with the more definitive three-year test.*

[2] *It should be noted that Section 2042 incident of ownership rule is not limited to the situation where an insured is listed as the owner of a policy. There are situations where an insured can be deemed to have an incident of ownership in a policy owned by a business or trust. In situations where policy ownership by a trust or business is attributed to the insured the three-year inclusion rule applies when the business or trust transfers the policy.*

[3] *Be aware – there are situations that can lead to estate inclusion of the proceeds of a policy that has been transferred to an ILIT under other Sections of the Internal Revenue Code. Inclusion may result when the insured transfers an existing policy insuring his or her life to an ILIT in which he or she serves as the trustee or retains certain proscribed interests in the policy (power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, to obtain a loan from the insurer, etc.). Inclusion may also occur when the insured is a power holder with respect to trust property.*

[4] *Estate of Silverman, 61 T.C. 338 (1973); Estate of Friedberg v. Commission, T.C. Memo 310 (1992). See also PLR 9128008.*

[5] *IRC § 2035(d); Treas. Reg. § 20.2035-1(e).*

[6] *Reg. § 25.2512-6(a).*

[7] *United States v. Allen, 293 F.2d 916, (10th Cir. 1961).*

[8] *TAM 9413045.*

[9] *IRC §101(a)(2),*

[10] *Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975). See PLRs 200228019, 200247006, 200514001, 200514002, 200518061, 200606027 and 200636086.*