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IRS Confirms Treatment of Life Insurance Policy Transfers Involving Grantor Trust for Transfer for Value Purposes

The IRS recently issued Rev. Rul. 2007-13, which provides that the grantor of a trust taxed as a wholly-owned grantor trust for federal income tax purposes is deemed the owner of any life insurance policy held by such trust for purposes of the transfer for value rule under IRC §101(a)(2). The ruling limits the impact of the transfer for value rule on certain transfers of life insurance policies involving grantor trusts.

Background. Generally, gross income does not include amounts received under a life insurance contract by reason of the insured's death. IRC §101(a)(2), however, provides that in the case of an insurance contract transferred for valuable consideration, the exclusion is limited to the sum of the consideration, premiums and other amounts subsequently paid by the transferee for the contract. An exception to the "transfer for value" rule applies if the transfer of the insurance contract is made to the insured.

Ruling. Confirming its position in several recent private letter rulings (*see* PLRs 200636086, 200120007 and 200228019), the IRS ruled that the transfer of a life insurance contract between two wholly-owned grantor trusts created by the same grantor is not a transfer for valuable consideration within the meaning of IRC §101(a)(2). In addition, the transfer of a life insurance contract from a non-grantor trust to a grantor trust that is wholly-owned by the insured is a transfer to the insured under IRC §101(a)(2)(B) and thus qualifies for the exception to the transfer for value rule. The IRS used Rev. Rul. 85-13 as the basis for its reasoning, which provides that "a transaction between a grantor of a trust that is treated as owned by the grantor for federal income tax purposes is disregarded."

Importance. Unlike the earlier private letter rulings, Rev. Rul. 2007-13 provides taxpayers with *binding* guidance regarding the treatment of life insurance sales involving grantor trusts. Thus, subject to the cautions noted below, the ruling offers a potential exit strategy for taxpayers with irrevocable insurance trusts that no longer meet their needs, due to changes in their family and/or financial circumstances. For example, the taxpayer could create a new, wholly-owned grantor trust designed to purchase the life insurance policy or policies held by the existing trust.

Cautions. Although this revenue ruling provides confirmation of the recent IRS position in this area, it fails to address many important tax and non-tax issues, including the following:



Tax issues

What Makes a “Grantor Trust?” Rev. Rul. 2007-13 simply assumes that the subject trusts qualify as grantor trusts for federal income tax purposes and thus offers no clarification as to what powers definitively make a trust a wholly-owned grantor trust (*e.g.*, Is the power under §677(a)(3) to use trust income to pay premiums on a policy insuring the grantor sufficient?). Unfortunately, the IRS has also decided that it will not issue rulings regarding a trust’s classification as a grantor trust for federal income tax purposes (*see* Rev. Proc. 2007-3).

Gain Recognition. A sale of an insurance policy from a non-grantor trust to a grantor trust will cause the non-grantor trust to recognize gain upon the transfer, if there was any appreciation in the policy at the time of sale. Also, the ruling provides no guidance as to how to determine the prior owner’s “basis” in the life insurance contract.

Potential Gift Tax Exposure. A grantor may seek to avoid the three year inclusion rule under IRC §2035 by selling an insurance policy to his or her grantor trust for “fair market value,” in reliance on the exception provided for a “bona fide sale for adequate consideration” under IRC §2035(d). The potential liability arises in determining fair market value. Since an active secondary market now exists for life insurance policies, the price a seller could obtain for a policy in such a market may far exceed the standard measures used for policy valuation (cash surrender value or interpolated terminal reserve). If the IRS determines that a policy sold for its cash surrender value did not obtain its “fair market value,” there may be gift tax exposure on the difference. In addition, the “bona fide sale” exception may not apply, causing inclusion of the policy’s death benefit in the estate of the grantor/insured, if he or she does not survive for three years after the sale.

Non-Tax Issues

Fiduciary Concerns. The ability to sell a policy from one trust to another grantor trust may be seen as a way to amend, effectively, the terms of an irrevocable trust. The grantor could sell the policy to a new grantor trust that has more restrictive distribution powers, adds or changes beneficiaries, etc. The trustee of the selling trust, however, must consider its fiduciary duties to the selling trust’s beneficiaries. For example, from an investment perspective, would a prudent trustee sell an insurance policy with a significant death benefit for a much smaller amount? Will the sale essentially divest the interest of the trust beneficiaries, who may then consider suing for breach of fiduciary duty?

Valuation. As discussed above, the trustee of a trust that owns an insurance policy will have difficulty in determining the “fair market value” of the policy for purposes of the sale. While the purchasing trust and its grantor may want to purchase the policy for its interpolated terminal reserve or cash value, there is a significant possibility that the selling trustee could



obtain a much higher price on the secondary market. Failure to explore this market and alternate valuations prior to the sale may expose the selling trustee to fiduciary liability.

Conclusion. While Rev. Rul. 2007-13 provides clarity and binding guidance regarding the application of the transfer for value rule to transfers of life insurance policies involving grantor trusts, the ruling may have also opened a Pandora's Box of tax and non-tax issues, which, in particular, impact the trustees involved in such transactions. Thus, taxpayers and trustees should proceed with caution in this area and enter such sale transactions only after careful consideration, with their advisors, of all the potential risks and liabilities.

Cites: Rev. Rul. 2007-13, 2007-11 IRB; Rev. Rul. 85-13, 1985-1 C.B. 184; Steve Leimberg's Estate Planning Newsletter #1088 (Feb. 19, 2007) at <http://www.leimbergservices.com>; "Ruling Explains Tax Treatment of Life Insurance Transfers to and from Grantor Trusts," Federal Taxes Weekly Alert (preview) 02/22/2007, Vol. 53, No. 08; AALU Bulletin No. 07-23, Feb. 20, 2007.



Albany 518.689.1400	Houston 713.374.3500	Sacramento 916.442.1111
Amsterdam + 31 20 301 7300	Las Vegas 702.792.3773	Silicon Valley 650.328.8500
Atlanta 678.553.2100	Los Angeles 310.586.7700	Tallahassee 850.222.6891
Boca Raton 561.955.7600	Miami 305.579.0500	Tampa 813.318.5700
Boston 617.310.6000	New Jersey 973.360.7900	Tokyo + 81 3 3264 0671
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Delaware 302.661.7000	Orlando 407.420.1000	West Palm Beach 561.650.7900
Denver 303.572.6500	Philadelphia 215.988.7800	Zurich + 41 1 364 26 00
Fort Lauderdale 954.765.0500	Phoenix 602.445.8000	

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