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## **SPLIT OF ONE LIFE INSURANCE POLICY INTO TWO IS NOT A TAXABLE EXCHANGE OR SALE**

In Private Letter Ruling 200652043, issued on December 29, 2006, the Internal Revenue Service (“IRS”) ruled that a joint owners’ proposed split of a single life insurance policy into two separate policies would *not constitute a taxable sale, exchange or disposition* for federal income tax purposes. The PLR relied heavily on the fact that the terms, benefits and rights under the two new contracts were *exactly* the same as under the original contract. Thus, the ruling provides important guidance for joint owners of a life insurance policy who seek to terminate their co-ownership.

**Background.** A banking corporation and its affiliates created a partnership to purchase and hold a group flexible premium variable life insurance policy and a certain number of associated un-leveraged life insurance certificates in order to finance various employee benefits.

Taxpayer wanted the insurer to partition the group life insurance policy and a number of insurance certificates by providing two separate life insurance contracts and two separate certificates for each original certificate. The insurer would allocate the premiums paid, death benefits and cash value between the separate contracts and certificates based upon the partners’ respective ownership percentage in the original contract and certificates. All other terms of the separate contract and certificates, however, would remain identical to those under the original contract and certificates.

**Key Factor: Nothing Changed.** While the PLR provides a substantial analysis of several life insurance issues, the main factor in each ruling was that nothing about the terms, death benefits, cash value, etc. of the separate contracts or certificates would change, other than an adjustment of the death benefits and cash value attributable to the separate contracts and certificates based on the partners’ relative ownership percentages prior to the partition. In other words, both parties would own the exact same property interests before and after the partition.

**Summary of Key Issues and Rulings.** The PLR provided rulings involving numerous sections of the Internal Revenue Code (“Code”), including but not limited to the following:

Code §1001: Sale or Disposition. The IRS ruled that the partition will not be a sale or other disposition under §1001(a) (which provides that gain or loss from the *sale or other disposition of property* is based on the amount realized from the sale and the seller’s adjusted basis in the property) because the separate contract and certificates held by each partner will: (1) reflect the same relative ownership percentages, (2) have the same terms and (3) insure the same lives as provided in the original contract and certificates. Since the partners will own essentially the same property both before and after the partition, there will be no sale or other disposition of property as required by §1001(a).

Code §1035: Non-Taxable Exchange of Life Insurance Contracts. Because the partition will not result in a taxable sale, exchange or disposition, the partition will not be treated as a §1035 exchange of life insurance contracts.



*Code §101 – Transfer for Value.* Because there was no sale, exchange or other disposition, the partition will not result in a transfer for value under §101. In addition, the partnership's liquidating distribution of the separate contracts and certificates will not result in a transfer for value, because the basis of such contracts in the hands of the taxpayer will be determined by reference to the partnership's basis in the original contract.

**Application.** This PLR provides potential guidance in situations where joint owners of insurance policies seek to terminate their joint ownership, including the following:

- **Elimination of Joint Ownership Difficulties.** While some joint ownership arrangements may have arisen voluntarily, in order to ease the burden of premium payments, others may be involuntary. For example, joint ownership may have been created to avoid transfer for value issues, a sale of the policy or through the joint owners' receipt of the policy by gift or inheritance. Regardless, in a joint ownership arrangement, none of the joint owners may exercise policy-owner rights unilaterally or without the consent of the other owners. In addition, premium payments on the policy will not be abated if one owner fails to pay his or her share. Thus, co-owners of a policy may wish to escape the constraints of joint ownership through a split of the policy into separate contracts.
- **Entity Liquidation.** Splitting a single insurance policy may facilitate the liquidation of entities (*e.g.*, partnerships) designed specifically to hold life insurance to fund employee benefits arrangements (as in the case above), shareholder buy-sell agreements, etc., where the purpose for the policy no longer exists but the continuation of the policy is sound from an investment perspective. Upon liquidation, the former partners will likely desire separate policies in order to avoid the constraints of joint ownership.
- **Split Dollar Termination.** Employers and employees may wish to terminate certain split dollar insurance arrangements organized under a joint ownership plan. Note, however, that there is a practical problem, particularly with a variable policy, of tracking what each party owns at any point during the policy's joint ownership, and the arrangement may not provide each party with an undivided interest in all the incidents of ownership of the contract. Thus, it may not be as easy to determine ownership percentages and respective rights under the original and separate contracts as it was for the parties in PLR 200652043. Furthermore, valuation of the respective ownership interests in a policy may be difficult, since the active secondary market for life insurance has undermined the typical policy valuation standards (*e.g.*, cash surrender value). The IRS has become increasingly dissatisfied with using cash value as the measure of a policy's value, particularly in split dollar arrangements.

**Conclusion:** The PLR makes the standard clear: joint owners seeking a split of one insurance contract into two must ensure, at a minimum, that there are absolutely no changes between the terms, benefits, cash value, etc. under the original contract and the newly issued separate contracts in order to avoid a taxable event. If that requirement is satisfied, then determinations with regard to the original contract, including those determinations based on the original issue date, will continue to apply to each of the newly issued, separate life insurance contracts.

Cites: PLR 200652043; Code §§72(c)(1); 72(e)(6); 264; 732; 1001; 1011; 1035; 7702; and 7702A; Steve Leimberg's Estate Planning Newsletter # 1072 (January 4, 2007) at <http://www.leimbergservices.com>.



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