UIL Nos. 101.01-02 351.13-00 721.00-00 761.00-00 2042.05-00 7701.02-03

CC:DOM:FI&P:4/PLR-112804-99
PLR-114658-99
PLR-114659-99
PLR-114660-99
JANUARY 24, 2000

LEGEND:

FLP =

LLC =

Trust 1 =

Trust 2 =

Trust 3 =

Policy 1 =

Policy 2 =

Policy 3 =

Policy 4 =

State =

Date 1 =

Date 2 =

H =

W =

X =

Y =

Z =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

m =

n =

p =

q =

Dear :

This is in response to your letter dated July 12, 1999, and additional submissions on behalf of FLP, H, W, and Trust 3 (referred to collectively as "Taxpayers"), requesting rulings concerning the income and estate tax consequences resulting from the formation of FLP and the transfer of policies insuring the lives of H and W to FLP.

FACTS

In 1984, H created Trust 1. W, H's spouse, and Y, a nonadverse party within the meaning of § 672(b) of the Internal Revenue Code, are the trustees of Trust 1. Under the trust instrument, the trust income and corpus may, in the discretion of Y, be used to pay premiums on policies insuring the life of H. Trust 1 currently holds only one asset, Policy 1, an insurance policy on the life of H. Under the provisions of Trust 1, Y may sell or assign any insurance policies owned by Trust 1.

In 1988, H created Trust 2. Y and Z, two nonadverse parties within the meaning of § 672(b) of the Code, are the trustees of Trust 2. Trust 2 currently holds Policy 2 and Policy 3, two second-to-die policies each insuring the joint lives of H and W. Trust 2's only other asset is Policy 4 insuring the joint lives of H and W. Taxpayers represent that Policy 4 has little cash value, and will soon lapse. Under the provisions of Trust 2, the trustees may sell or assign any insurance policies owned by Trust 2.

In 1982, H created Trust 3 for the benefit of H's issue. W and Y are the trustees of Trust 3. Taxpayers represent that, as of Date 2, the assets of Trust 3 consisted of cash and marketable securities having a value of approximately $i, real estate having a value of approximately $j that was subject to a mortgage in the amount of approximately $p, and promissory notes with a combined principal balance of $c. The promissory notes evidence loans made by Trust 3 to Trust 1 and Trust 2. Under the terms of the loan agreements and promissory notes, the loans are payable within three months of written demand by the lender, interest on the loans is determined with reference to the short-term interest rate established under § 1274(d) of the Code, and interest is payable on December 31 of each year that the loans are outstanding. Further, the loan documents state that the loans are unsecured obligations. Trust 1 and Trust 2 used the proceeds of the loans from Trust 3 to pay insurance premiums on the life insurance policies owned by the trusts.

In 1994, H loaned $h to Trust 1. Trust 1 gave H a promissory note evidencing the loan. The terms of the loan and promissory note are the same in all material respects as the loans and promissory notes with respect to the borrowing by Trust 1 and Trust 2 from Trust 3. Trust 1's promissory note to H states that H's loan to Trust 1

is an unsecured obligation. Trust 1 used the proceeds of H's loan to pay insurance premiums on Policy 1.

Taxpayers represent that on Date 1, Trust 3, H, and W formed LLC pursuant to the Limited Liability Act of State.[1] Taxpayers represent that the following contributions were made to LLC within an approximately two week period commencing on Date 2. In exchange for all of the Class B membership units in LLC representing an n% ownership interest in LLC, Trust 3 contributed cash and marketable securities, comprising a particular custodial account held by a bank, having a value of approximately $k; real estate having a value of approximately $j; and LLC assumed a liability of Trust 3 in the amount of approximately $p. Prior to its assumption by LLC, the liability was attached to the real estate. In connection with the assumption, Taxpayers represent, that, in order to avoid State transfer taxes upon Trust 3's contribution of the realty to LLC, the parties entered into a substitution of collateral agreement replacing the real estate as collateral for the liability with the cash and securities of the custodial account. Thus, after their transfer to LLC, the cash and securities of the custodial account were subject to a liability of approximately $p, and the real estate was not subject to any liability. In exchange for Class A membership units in LLC, Taxpayers represent that H and W each contributed cash in the amount of $q. H and W each received an m% ownership interest in LLC. Taxpayers represent that, under the operating agreement of LLC, the Class A members have the authority and power to conduct and control the business, affairs and operations of LLC, while the Class B Members have limited rights to participate in the conduct and control of the business, affairs, and operations of LLC.

Taxpayers represent that, also on Date 1, Trust 3, H, and W formed FLP pursuant to the Revised Uniform Limited Partnership Act of State,[2] and that the

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[1] The stated general purpose of LLC is any and all lawful purposes for profit, income and gain, including but not limited to, the purchase, acquisition, subdivision, improvement, development, construction, lease, management, sale and mortgage of LLC property. The stated business purpose of LLC is to make profits, increase wealth, manage and preserve assets of the X family members, preserve X family harmony, maintain control of X family assets, continue ownership of X family assets and restrict the rights of persons not members of the X family from acquiring any interest in X family assets, and among other things, provide flexibility in business planning not available through trusts or other business entities.

[2] The stated general purpose of FLP is to engage in all businesses permitted under the Revised Uniform Limited Partnership Act of State, including, but not limited to, acquisition and investment in real or personal property of any kind including stocks, bonds, notes, evidences of indebtedness of any person, domestic or foreign, insurance policies, general or limited partnership interests, membership interests in any limited

following contributions in exchange for partnership interests were made to FLP within an approximately two week period commencing on Date 2. Trust 3 contributed cash and marketable securities having a value of approximately $a, its n% interest in LLC having a value of approximately $b, and the promissory notes from Trust 1 and Trust 2 having a combined face value of approximately $c in exchange for an n% limited partnership interest in FLP. H contributed cash in the amount of $g and the promissory note from Trust 1 with face amount $h. The sum of the cash and the face amount of the note contributed by H was $d. W contributed cash of $d to FLP. In exchange for their contributions, H and W each received an m% general partnership interest in FLP.

The FLP partnership agreement provides that the general partners control the management and investment decisions of the partnership. However, under the FLP partnership agreement, if the partnership owns a life insurance policy (or interest therein) insuring the life of any partner, or the joint lives of any partner or possesses any incident of ownership with respect to such policy or policies, the insured partner has, in the case of a single life policy, or the insured partners have, in the case of a joint life policy, no right or power to exercise or to otherwise participate in the exercise of any of the incidents of ownership with respect to such policy or policies. The exercise of any incident of ownership in any such policy is to be exercised only by a majority of the partners, including limited partners, other than the insured partner in the case of a single life policy, or the insured partners, in the case of a joint life policy. In addition, W in the capacity of co-trustee of Trust 3, is not permitted to participate in the exercise of any incident of ownership or in any decision of the partnership regarding any policy insuring W's life.

FLP plans to demand payment on the promissory notes. Trust 1 and Trust 2 each propose to satisfy their respective loan obligations by transferring Policies 1, 2, and 3 to FLP. (Taxpayers represent that Policy 4 will not be so transferred.) Taxpayers represent that the proposed transfers of life insurance policies by Trust 1 and Trust 2 to FLP will discharge debt obligations that are enforceable under State law and that are valid debt obligations for federal income tax purposes. The policies will be transferred for an amount equal to the value of the respective trust's interest in the policy or policies, as determined under § 25.2512-6(a) of the Gift Tax Regulations. Specifically, the policies will be valued by taking the sum of the interpolated terminal reserve value of each policy at the date of the proposed transfer, as obtained from the issuing

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liability company, or any other securities. The stated business purpose of FLP is to make profits, increase wealth, manage and preserve assets of the X family members, preserve X family harmony, maintain control of X family assets, continue ownership of X family assets and restrict the rights of persons not members of the X family from acquiring any interest in X family assets, and among other things, provide flexibility in business planning not available through trusts or other business entities.

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insurance company, 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. Taxpayers represent that the life insurance policies to be transferred to FLP will have sufficient value to fully discharge the debt obligations of Trust 1 and Trust 2. If the interpolated terminal reserve value (plus the proportionate premium amount extending beyond the proposed date of transfer) of the policies is greater than the balance due under the notes, then, Taxpayers represent, the trusts will withdraw an amount of cash value from the policies such that the interpolated terminal reserve value (plus the proportionate premium amount extending beyond the proposed transfer date) of the policies will equal the balance due under the notes. Taxpayers also represent that, as the new owner of the transferred policies, FLP will designate itself as the beneficiary of the policies and pay all policy premiums.

Taxpayers assert that the proposed transfers of the life insurance policies to FLP will accomplish several business purposes. First, neither Trust 1 nor Trust 2 has sufficient income to pay the full amount of the premiums on the policies they respectively own. On the other hand, it is anticipated that FLP will have sufficient cash receipts to pay policy premiums. Second, transferring the policies to FLP will enable Trust 1 and Trust 2 to satisfy their outstanding loan obligations. Third, FLP's acquisition of the policies will provide additional diversification of FLP's investments, consolidation of the X family's assets, and additional assets to FLP on the death of the insureds thereby enhancing the value of FLP for family purposes.

After the planned transfer of the life insurance policies to FLP, Taxpayers represent that FLP's assets will consist of the following : (1) marketable securities having an approximate value of $a; (2) an n% interest in LLC having an approximate value of $b; (3) three life insurance policies having an approximate value of $e; and (4) approximately $f in cash.

Additionally, Taxpayers make the following additional representations:

1. No election will be filed for FLP to be treated as other than its default federal tax classification (a partnership) under § 301.7701-3(c)(1) of the Procedure and Administration Regulations.

2. The cash value of the three insurance policies that will be transferred to FLP will represent less than 50 percent of FLP's assets.

3. Other than the contributions described above, neither Trust 3, H, nor W has made, or intends to make, any additional contributions to LLC.

4. Currently, no negative balance exists in any member's account in LLC and no action is intended to be taken by LLC that would result in the creation of a negative

balance in any member's capital account.

5. No other members have been admitted to LLC since its inception and there is no current plan or intent to admit other members.

6. There have been no non-pro rata contributions to FLP since its inception and no contributions are currently intended.

7. Neither Trust 3, H, nor W has received, or intends to receive, additional limited partnership units as a result of additional capital contributions, either deemed to be contributed, by gift of another partner, or otherwise.

8. There is no plan or intent to make any additional transfers to either FLP or LLC by any transferor.

LAW AND ANALYSIS

Sections 761(a) and 7701(a)(2) of the Code provide 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, within the meaning of the Code, a trust, estate, or corporation. Under § 301.7701-3(b)(1) of the Procedure and Administration Regulations, unless it elects otherwise, a domestic eligible entity formed after January 1, 1997, with two or more members, is treated as a partnership for federal tax purposes.

The term "partner" means a member of a partnership. Sections 761(b) and 7701(a)(2).

Section 721(a) of the Code provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 721(b) of the Code provides that § 721(a) shall not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of § 351) if the partnership were incorporated.

Section 1.351-1(c)(1) of the Income Tax Regulations provides that a transfer to an investment company will occur when: (i) the transfer results, directly or indirectly, in diversification of the transferors' interest; and (ii) the transferee is (a) a regulated investment company (RIC), (b) a real estate investment trust (REIT), or (c) a corporation more than 80 percent of the value of whose assets (excluding cash and non-convertible debt obligations from consideration) are held for investment and are readily marketable stock or securities, or interests in RICs, or REITs.

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Section 1002 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997) ("TRA97"), amended § 351(e) of the Code for transfers after June 8, 1997, in taxable years ending after such date, subject to certain transitional relief provisions. Section 1002 of TRA97 is intended to expand the types of assets considered in determining whether a transfer is to a transferee described in § 1.351-1(c)(1)(ii)(c). Thus, under TRA97, the definition of "readily marketable stock and securities" now includes: (i) money; (ii) stock and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives; (iii) foreign currency; (iv) interests in RICs, REITs, a common trust fund, a publicly traded partnership or similar equity interest which pursuant to its terms is readily convertible into, or exchangeable for, any of the preceding assets; (v) certain precious metals; (vi) interests in any entity whose assets are substantially those previously described; or (vii) any other asset so designated by the Secretary.

Section 1.351-1(c)(2) of the Regulations states that the determination of whether a corporation is an investment company shall ordinarily be made by reference to the circumstances in existence immediately after the transfer in question. However, where circumstances change thereafter pursuant to a plan in existence at the time of transfer, this determination shall be made by reference to the later circumstances.

Section 1.351-1(c)(4) of the Regulations provides that for purposes of § 1.351-1(c)(1)(ii)(c), stock in subsidiary corporations is disregarded and the parent corporation is deemed to own its ratable share of its subsidiaries' assets. For these purposes, a corporation is considered a subsidiary if the parent owns 50% or more of: (i) the combined voting power of all classes of stock entitled to vote; or (ii) the total value of shares of all classes of stock outstanding.

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) 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.

Section 2042(2) of the Code provides that the value of the decedent's gross estate includes the proceeds of all life insurance policies on the decedent's life receivable by beneficiaries other than the decedent's executor to the extent that the decedent possessed at death any incidents of ownership, exercisable either alone or in conjunction with any other person.

Section 20.2042-1(c)(2) of the Estate Tax Regulations provides that the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally, the term has reference to the right of the insured or the insured's estate to the economic benefits of the policy. Thus, it includes the 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, or to obtain from the insurer a loan against the surrender value of the policy.

Partnership Rulings

Taxpayers have requested a ruling that FLP is a partnership for federal tax purposes. Taxpayers also request a ruling that no gain will be recognized under § 721 of the Code as a result of the transfer of assets to FLP by Trust 3, H, and W in exchange for partnership interests in FLP.

Based solely on the facts submitted and representations made, we conclude that FLP will be treated as a partnership for federal tax purposes and that Trust 3, H, and W will be treated as partners in FLP for federal tax purposes.

Under § 351(e) of the Code, real estate is not an asset listed in the definition of "readily marketable securities." Immediately after the transfers to FLP, the value of the real estate in FLP comprises more than 20 percent of the total value of FLP's assets. Thus, in this case, treating FLP as incorporated, FLP does not qualify as an "investment company" under § 1.351-1(c) due to the large asset value of the real estate contributed. Accordingly, we have determined, treating FLP as incorporated, that the transfers by the partners to FLP should not be treated as transfers to an investment company within the meaning of § 351. Thus, based solely on the facts submitted and representations made, we conclude that no gain will be recognized under § 721 as a result of the transfer of assets to FLP by Trust 3, H, and W in exchange for partnership interests in FLP.

Transfer-for Value Ruling

Taxpayers represent that the proposed transfers of life insurance policies by Trust 1 and Trust 2 to FLP for an amount equal to the value of the respective trust's interest in the policy or policies, as determined under § 25.2512-6(a) of the Gift Tax Regulations, will discharge debt obligations that are enforceable under State law and that are valid debt obligations for federal income tax purposes. Thus, the proposed transfers of life insurance policies will be "transfers for a valuable consideration" as defined in § 1.101-1(b)(4) of the Regulations. The transferee of the proposed transfers will be FLP, a partnership for federal tax purposes. Further, all of the insureds under the policies to be transferred will be partners of FLP at the time the policies are transferred. Thus, based on the facts submitted and representations made, the proposed transfers of Policies 1, 2, and 3 to FLP 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 FLP will receive under these contracts upon the deaths of H and W.

Estate Tax Ruling

Taxpayers have requested a ruling that the proposed transfers of insurance policies to FLP will not result in either H or W possessing incidents of ownership under § 2042(2) of the Code in any of the policies by reason of their respective general partnership interests in FLP.

Incidents of ownership are measured by a "general, legal power to exercise ownership without regard to the owner's ability to exercise it at a particular moment." Commissioner v. Estate of Noel, 380 U.S. 678, 684 (1965). See also Estate of O'Daniel v. United States, 6 F.3d 321 (5th Cir. 1993); Estate of Bartlett v. Commissioner, 54 T.C. 1590 (1970), acq., 1971-2 C.B. 1. "The very phrase 'incidents of ownership' connotes something partial, minor, or even fractional in scope. It speaks more of possibility than of probability." United States v. Rhode Island Hospital Trust Co., 355 F.2d 7, 10 (1st Cir. 1966). When the insured cannot initiate the acts associated with the incidents of ownership, but can only consent to or veto the exercise of the incidents of ownership by another, the courts have held that the veto power itself constitutes an incident of ownership over the policy. Where the insured must consent before the actions of others effectively alter a revocable trust, the insured holds incidents of ownership in a life insurance policy held by the trust. See Estate of Karagheusian v. Commissioner, 233 F.2d 197 (2d Cir. 1956).

In the instant case, under the FLP partnership agreement, the general partners control the management and investment decisions of the partnership. However, an insured partner, whether limited or general, is prohibited from participating in the

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exercise of any incident of ownership with respect to a partnership-held policy insuring his or her life. Further, W, as trustee of Trust 3, which holds a limited partnership interest in FLP, will be precluded from exercising any incident of ownership over the policies insuring W's life. Thus, neither H nor W in their capacity as general partners, will be able to exercise any incidents of ownership with respect to a policy held by FLP that insures their respective lives or their joint lives. Based solely on the facts submitted and representations made, we conclude that H and W will not possess any incidents of ownership under § 2042(2) of the Code with respect to Policies 1, 2, and 3 by reason of their general partnership interests in FLP.

CONCLUSIONS

1. FLP will be treated as a partnership for federal tax purposes. Trust 3, H, and W will be treated as partners in FLP for federal tax purposes.

2. No gain will be recognized under § 721 of the Code as a result of the transfer of assets to FLP by Trust 3, H, and W in exchange for partnership interests in FLP.

3. The proposed transfers of Policies 1, 2, and 3 to FLP 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 FLP will receive under these contracts upon the deaths of H and W.

4. H and W will not possess any incidents of ownership under § 2042(2) of the Code with respect to Policies 1, 2, and 3 by reason of their general partnership interests in FLP.

CAVEATS

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

2. Specifically, no opinion is expressed or implied concerning FLP's federal tax classification as a partnership if FLP disposes of its interest in LLC.

3. Specifically, no opinion is expressed or implied concerning whether Policies 1,2, and 3 are "life insurance contracts," as defined in § 7702(a) of the Code or are "flexible premium life insurance contracts" issued before January 1, 1985, that meet the requirements set forth in § 101(f)(1) of the Code.

4. Specifically, no opinion is expressed or implied regarding the federal gift tax consequences of the transactions set forth in this ruling request.

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5. Specifically, no opinion is expressed or implied concerning the validity for federal tax purposes of any of the loans or promissory notes referenced above. Further, no opinion is expressed or implied regarding the applicability of §§ 1271-1275 and § 7872 of the Code to the purported loans.

6. Specifically, no opinion is expressed or implied regarding whether H (the grantor) should be treated as the owner of any portion of Trust 3 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,
Assistant Chief Counsel
(Financial Institutions and Products)

By: /S/
Donald J. Drees, Jr.
Senior Technician Reviewer
Branch 4