

Internal Revenue Service

Department of the Treasury

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and 2503.03-01

Washington, DC 20224

Ruling: **199905010**

Release Date: 2/5/1999

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:7-PLR-118513-97

Date:

OCT. 30, 1998

Legend

A:

B:

C:

D:

Corporation:

Partnership:

State:

Date 1:

Date 2:

x:

:

We received a request for rulings and subsequent correspondence submitted on your behalf by your authorized representative. This letter is in reply to your requests.

FACTS

A and B are married. They have two children, C and D. A is an employee and the majority shareholder of Corporation. A plans to retire soon. C and D are actively involved in the management of Corporation. C and D also own stock in Corporation. C and D acquired their stock in Corporation by gift from A.

Corporation currently owns a "life insurance contract" on A's life. The contract is an adjustable whole life insurance contract issued by a domestic commercial insurance carrier. Corporation has designated itself as the beneficiary of the policy. Corporation no longer needs this contract and wishes to sell it to C and D. C and D believe that the purchase of the life insurance contract would be a good investment.

A and B are also general partners and limited partners in Partnership. Partnership was organized on Date 1 under the Uniform Limited Partnership Act of State. Partnership's purpose is to engage in investment activities.

Under Partnership agreement, profits and losses allocable to the limited partners and distributions of distributable cash must be allocated and distributed to the limited partners in proportion to their capital contributions. Distributable cash consists of all cash revenues of Partnership less amounts spent by Partnership during the period and working capital or reserves or other amounts the general partners reasonably deem necessary or appropriate for the proper operation of Partnership business or its winding up and liquidation.

Partnership currently has investment assets of approximately \$x in value. Partnership will dissolve no later than Date 2. Partnership has not elected to be treated as an association taxable as a corporation under § 301.7701-3(b) of the Income Tax Regulations.

A proposes to give portions of his limited partnership interest in Partnership to C and D in the current year. It is represented that the value of the limited partnership interest in Partnership that A proposes to give to each child will be approximately \$10,000 and that the gifts will occur before C and D acquire the life insurance contract from Corporation. Further, it is represented that, A plans to continue gifting limited partnership interests in Partnership to C and D over the next two to three years and that, if the value of the limited partnership interests in Partnership given to each child

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exceeds the annual exclusion allowable under § 2503(b), B has agreed to consent to split gift treatment under § 2513.

A also intends to continue gifting Corporation stock to C and D. Under the current gifting pattern, A proposes to dispose of his controlling interest in Corporation before the life insurance policy transaction described below is executed. Neither C nor D, however, will hold a majority interest in Corporation after the gifts have been made.

Subsequent to the initial gifts of partnership interests to each of C and D, C and D propose to purchase the life insurance contract for the greater of its interpolated terminal reserve value or its cash value. The closing of the sale will be accomplished by the corporation executing a bill of sale evidencing the sale of the life insurance contract to C and D. C and D will then execute a demand note in favor of Corporation in the amount of the purchase price of the life insurance contract. Interest on the demand note will accrue on the unpaid balance at the applicable federal rate under § 7520.

Simultaneous with the closing, C and D will obtain a loan from the commercial insurance carrier that issued the life insurance contract. The amount of the loan will be approximately in the amount of the cash value of the life insurance contract. C and D will use the loan proceeds to pay off Corporation's demand note if sufficient cash is available. If the loan is less than the sales price of the life insurance contract, an amount will remain to be paid on the demand note. Corporation will have no security interest in the life insurance contract after closing. The death benefit under the life insurance contract will be reduced by any unpaid loan amount.

After the sale, C and D will hold jointly all incidents of ownership in the life insurance contract. For example, only C and D will be able to obtain policy loans, assign or surrender the contract, designate beneficiaries and exercise all other rights with respect to the contract.

Immediately after the sale, C and D will designate themselves beneficiaries of the contract. They will pay all premiums due on the contract. Upon receipt of the proceeds at A's death, C and D will share equally in the death proceeds.

For purposes of the ruling under § 101(a)(2), it is represented that Partnership is a valid partnership under subchapter K. Further, it, also, is represented that following the gifts of the limited partnership interests to C and D, C and D will be partners of A under subchapter K.

RULINGS REQUESTED

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(1) The proposed transfer of the life insurance contract from Corporation to C and D will be a transfer to a partner of the insured within the meaning of § 101(a)(2)(B) and will not be subject to the transfer for value rules of § 101(a)(2).

(2) The proposed transfer of limited partnership interests in Partnership from A and B to C and D will be eligible for the annual \$10,000 exclusion from gift tax under § 2503(b).

(3) Section 2035(a) will not apply to include the proceeds of the life insurance policies in A's gross estate.

LAW AND ANALYSIS

ISSUE 1-EXCEPTION TO THE TRANSFER FOR VALUE RULE

Section 101(a)(1) 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) provides that if a life insurance contract, or any interests 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 or the consideration and the premiums and other amounts subsequently paid by the transferee.

An exception to the general rule of § 101(a)(2) is provided in § 101(a)(2)(b) when the life insurance contract is transferred to the insured, to a partner of the insured, or 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, amounts received by the contract beneficiaries are completely excluded from gross income, as provided by § 101(a)(1).

The term "transfer for valuable consideration" is defined for purposes of § 101(a)(2) in § 1.101-1(b)(4) as any absolute transfer for value of the right to receive all or a part of the proceeds of a life insurance policy.

ISSUE 2-GIFT OF PRESENT INTEREST IN PROPERTY

Section 2501(a)(1) provides for the imposition of a tax on the transfer of property by gift. Section 2511 provides that the gift tax applies to a transfer by way of gift 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 2503(b)(1) provides that in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the

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first \$10,000 of such gifts to such person shall not be included in the total amount of gifts made during such year. The annual exclusion is only allowed for gifts of present interests in property. Under § 2503(b)(2), this \$10,000 amount is subject to adjustment annually to reflect the increase in the cost of living index. Section 25.2503-3(b) of the Gift Tax Regulations provides that a present interest in property is an unrestricted right to the immediate use, possession, or enjoyment of the property or the income from the property (such as a life estate or a term certain). Thus, to be eligible for the annual exclusion from gift tax under § 2503(b), the proposed transfers by A and B of limited partnership interests in Partnership to C and D must constitute gifts of present interests in property.

In this case, the management powers possessed by A and B, as the general partners, authorize A and B, in determining Partnership distributions, to withhold only amounts that the general partners reasonably deem necessary or appropriate for the proper operation of Partnership business or its winding up and liquidation. The general partners must exercise such powers in a fiduciary capacity and are held to a high standard of conduct toward the limited partners. See generally, *In re USACafes, L.P. Litigation*, 600 A.2d 42 (Del.Ch.1991), and A.B. Willis, J.S. Pennell, P.G. Postlewaite, *Partnership Taxation* (4th Ed.1989), § 1.05.

ISSUE 3-GIFT WITHIN 3-YEARS OF DEATH

Under § 2035(a) as amended by the Taxpayer Relief Act of 1997, if the decedent made a transfer by trust or otherwise of an interest in property, or relinquished a power with respect to property, during the 3-year period ending on the date of decedent's death, and the value of such property (or an interest therein) would have been included in the decedent's gross estate under §§ 2036, 2037, 2038, or 2042, if such transferred interest or relinquished power had been retained by the decedent on the date of death, then the value of the gross estate shall include the value of any property which would have been so included. Other transfers made within three years of death are not includible in the gross estate. Further, transfers that are bona fide sales for adequate and full consideration in money or money's worth, made within three years of death, are not includible in the gross estate.

Section 2042(2) provides that the value of the gross estate includes the value of the amount receivable as insurance under policies on the life of the decedent by beneficiaries (other than the executor), with respect to which decedent possessed at the date of death any of the incidents of ownership in the policies, exercisable alone or in conjunction with any other person.

Section 20.2042-1(a)(2) provides that proceeds of life insurance that are not includible in the gross estate under § 2042 may, depending upon the facts of a particular case, be includible under some other section of the estate tax provisions of the Code. For example, if the decedent possessed incidents of ownership in an

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insurance policy on decedent's own life and gratuitously transferred all rights in the policy within 3 years of death, the proceeds would be includible under § 2035.

Section 20.2042-1(c)(6) provides that, if a decedent is the controlling stockholder in a corporation that holds a life insurance policy on the decedent's life and the proceeds of the policy are payable to a third party for nonbusiness purposes, the incidents of ownership held by the corporation will be attributed to the decedent through the decedent's stock ownership and the proceeds will be included in the decedent's gross estate under § 2042. For this purpose, a controlling stockholder is one who owns, at death, stock possessing more than fifty percent of the total combined voting power of a corporation.

Includibility of life insurance proceeds under § 2042(2) depends on the decedent's possession of incidents of ownership in the policy at death. Includibility of life insurance proceeds under § 2035(a), however, is based on a different rule. Section 2035(a) will apply if the decedent possessed an incident of ownership in the life insurance policy at some time during the three-year period prior to death and transferred such incident of ownership during the same period. Thus, the relevant frame of reference for purposes of § 2035 is not merely the time of death, but the three-year period preceding death. If during the three-year period preceding death, the decedent possessed incidents of ownership either directly or through an ownership interest in a corporation and the decedent subsequently relinquished the incidents of ownership by assignment of the policy or by the transfer of a sufficient amount of stock to cause divestment of control of the corporation, the application of § 2035(a) will be triggered. See Rev. Rul. 90-21, 1990-1 C.B. 172.

CONCLUSIONS

Based upon the information submitted and the representations set forth above we rule as follows:

(1) The transfer of the life insurance contract on the life of A by Corporation to C and D will be a transfer to a partner of the insured under § 101(a)(2)(B) and therefore, excepted from the transfer for valuable consideration rule of § 101(a)(2) provided that:

- (a) the contract qualifies as a life insurance contract under § 7702;
- (b) Partnership is a partnership for purposes of subchapter K; and
- (c) C and D are considered partners under subchapter K.

(2) The proposed transfers by A and B of the limited partnership interests in Partnership to C and D will be eligible for the annual exclusion from gift tax under § 2503(b) provided that:

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(a) A, B, C, and D act in a manner consistent with their representations that they are partners in Partnership; and

(b) C and D have rights as limited partners in Partnership that are consistent with the rights of limited partners contained in the agreement establishing Partnership, including the right to distributions of cash and property, the right to sell or assign their interests in Partnership (subject to the right of first refusal), voting rights, and rights on termination of Partnership.

(3) Section 2035 will not apply to the transfer of the insurance policies to C and D, provided that:

(a) A transfers controlling interests in Corporation more than three years before A's death, or

(b) The transfer of the life insurance policy to C and D constitutes a bona fide sale for adequate and full consideration in money or money's worth.

The rulings contained in this letter are based on information and representations submitted by the taxpayers and accompanied by a perjury statement executed by an appropriate party. 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.

We express or imply no opinion as to the tax treatment of the subject transaction under any section of the Code or regulations that is not specifically covered by this ruling or as to the tax treatment of any conditions existing at the time of, or effects resulting from the transaction. Specifically, we express no opinion as to whether the contract that is proposed to be transferred qualifies as a life insurance contract under § 7702(a). We express no opinion as to whether A and/or B must recognize gain or loss on the transfer of limited partnership interests to C and D. Further, we express no opinion as to whether the corporation will experience a taxable gain upon the sale of the contract. Finally, no opinion has been requested and no opinion is given as to whether C and D may deduct any interest paid or accrued on the loans.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Joseph H. Makurath

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Senior Technician Reviewer, Branch 7
Assistant Chief Counsel (P&SI)