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*ESTATE WISE PLANNING*TM

SINCE 1979

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State Real Estate Transfers: The IRS Estate and Gift Tax Program recently started working with state and county authorities in several states to determine if real estate transfers reported to them are unreported gifts. Although a tax may not be due, a gift tax return may be required for real estate transfers above the annual exclusion amount. Penalties will be considered on all delinquent taxable gift returns filed [e-News for Tax Professionals, August 3, 2009, Issue Number 2009-31]. For more information see: [Estate and Gift Taxes](#); [Gift Tax](#); and [Gift Tax Return](#). Not all states impose gift tax. Nevertheless, any gift of property, including real property, having a fair market value greater than the federal annual gift tax exclusion amount, must be reported on a United States Gift and (Generation-Skipping Transfer) Tax Return (Form 709). Since most states do not impose a state gift tax, it might be easy for a donor to overlook the necessity to file a Form 709. In these current economic conditions, the IRS is seeking ways to collect additional tax revenue by reminding taxpayers of the necessity to file Forms 709 for taxable gifts.

Life Insurance Policies Sold for Profit: A growing trend of grave concern to this author involves the sale of existing life insurance contracts to persons having no insurable interest in the insured's life. This practice has become so wide spread that the IRS has issued guidance to investors who buy existing life insurance contracts on the lives of insureds, having no *insurable interest* in the insured [Rev. Rul. 2009-14, 2009-21 I.R.B. 1]. "An *insurable interest*...is defined as a financial or otherwise undeniable interest in the preservation of the subject of the insurance—a building or contents in fire insurance, **the life insured in life insurance**. Such a person has a risk of genuine loss in the event of the destruction of the property or life." [Emphasis added] [Janice E. Greider, LL.B., F.L.M.I., C.L.U. and William T. Beadles, D.B.A., C.L.U., *Law and the Life Insurance Contract*, Richard D. Irwin, Inc., Homewood, ILL, 1968 Revised Edition, at 53]. It is the exchange of risk, *i.e.*, between the insurer and the insured, for certainty (*i.e.*, transfer of risk) that distinguishes the contract of insurance from the wagering contract. In a true wager, there is no risk until the wager is made. It is the wager that creates the risk. In insurance, the contract removes the risk and exchanges risk for certainty. "Thus, the only contract of insurance that is against public policy is a contract issued to someone without an insurable interest" [*Id.*, at 53-54]. Insurable interest is a requirement for a valid insurance contract under the law of most states [*Id.*, at 122].

Whether, and to what extent, an investor has an insurable interest when purchasing an existing life insurance contract on the insured's life is being widely debated among the states. For example, in the State of Oregon, this issue "...is under review as per the new market sales conditions [in the State of Oregon]. Investment sales and % of ownership [of a life insurance contract] would be a security in Oregon. The insurance companies are also working on this in their underwriting departments of compliance." [e-mail letter from Dennis W. Kuckartz, Insurance Consumer Advocate, State of

Oregon Department of Consumer & Business Services, Oregon Insurance Division, to Doug H. Moy, Jan. 27, 2009] Regardless of whether such an arrangement is deemed a security, the practice should not be permitted under any States' laws. The issue in Revenue Ruling 2009-14 is straightforward: What are the tax consequences to Investor under the three situations below upon the receipt of death benefits, or upon the receipt of sale proceeds, with regard to a term life insurance contract that was purchased for profit?

Situation (1). Brian (the Investor) is a United States citizen, residing in the United States, is a United States person as defined in IRC Section 7701(a)(30), determines taxable income using the cash method of accounting and files his income tax returns on a calendar year basis. On June 15, 2008, Brian purchased from Allan for \$20,000 a "life insurance contract" (as defined in IRC § 7702) issued on Allan's life. The contract was originally issued by Insurance Sales, a domestic corporation, to Allan on January 1, 2001. The contract was a **level premium fifteen-year term life insurance contract without cash surrender value**. At the time of purchase, the remaining term of the contract was 7 years, 6 months and 15 days. The monthly premium for the contract was \$500, due and payable on the first day of each month. As owner of the contract, Brian had the right to change the beneficiary and, pursuant to that right, named himself beneficiary under the contract immediately after acquiring the contract. Brian had no insurable interest in Allan's life and, except for the purchase of the contract, Brian had no relationship to Allan and would suffer no economic loss upon Allan's death. Brian purchased the contract with a view to profit. The contract in Brian's hands was not property described in IRC Section 1221(a)(1)-(8); *i.e.*, it was not *capital asset* property. The likelihood that Brian would allow the contract to lapse by failing to pay any of the remaining premiums was remote. On December 31, 2009, Allan died; and Insurable Sales paid \$100,000 under the life insurance contract to Brian by reason of Allan's death. Through that date, Brian had paid monthly premiums totaling \$9,000 to keep the contract in force.

Because Brian purchased the contract from Allan in exchange for a purchase price of \$20,000, Brian's acquisition of the contract was a "transfer for a valuable consideration." [IRC § 101(a)(2)] Neither the carryover basis exception of IRC Section 101(a)(2)(A) nor the exception for transfers involving parties related to the insured under IRC Section 101(a)(2)(B) applied. Accordingly, IRC Section 101(a)(1) excludes from Brian's gross income the amount received by reason of Allan's death; but IRC Section 101(a)(2) limits the exclusion to the sum of the actual value of the consideration paid for the transfer (\$20,000) and other amounts paid by Brian (\$9,000), or \$29,000. Brian must recognize \$71,000 of ordinary income, which is the difference between the total death benefit received (\$100,000) and the amount excluded under IRC Section 101 (\$29,000).

Situation (2). The facts are the same as in Situation (1), except that Allan did not die; and, on December 31, 2009, Brian sold the contract to Chuck (a person unrelated to Allan or Brian) for \$30,000. Remember, in Situation (1), Brian **paid** Allan \$20,000 for the policy on Allan's life and \$9,000 in monthly premiums to prevent the contract from lapsing. Therefore, Brian's adjusted basis for purposes of measuring gain on the sale to Chuck was \$29,000. The adjusted basis for determining gain or loss [IRC §§ 1011 and 1012] is generally the cost of the property as adjusted. [IRC § 1016; except as otherwise provided in subchapters O (§§ 1011 through 1092), C (IRC §§ 301 through 386), K (IRC §§ 702 through 777), and P (IRC §§ 1201 through 1298). Section 101(a)(2) has no bearing on the determination of the basis of a life insurance contract that is sold, because § 101(a)(2) applies only to amounts received by reason of the death of the insured.] Taxpayers are required to capitalize an amount paid to another party to acquire an intangible (including a life insurance contract) from that party in a purchase or similar transaction. [Treas. Reg. § 1.263(a)-4(c)(1)(iv)] The \$20,000 Brian paid Allan is included in Brian's cost basis. Brian also paid \$9,000 in monthly premiums to keep the policy from lapsing. The premiums paid by a secondary market purchaser of a term life insurance contract serve to create or enhance a future benefit for which capitalization is appropriate. Accordingly, Revenue Ruling 2009-14 requires a secondary market purchaser (*e.g.*, Brian) to capitalize premiums paid to prevent a term life insurance contract (without cash value) from lapsing. The Service will not challenge the capitalization of such premiums paid or incurred prior to the issuance of Revenue Ruling 2009-14. Therefore, Brian's adjusted basis for purposes of measuring gain on the sale to Chuck was \$29,000.

Brian is not required to reduce his basis in the life insurance contract by any cost of insurance charges which may have been imposed. "In Rev. Rul. 2009-13 [See *ESTATE WISE PLANNING*,™ "**Surrender or Sale of Life Insurance Contracts**," Vol. V, July 2009, page 1], *Century Wood Preserving*, *London Shoe*, and *Keystone Consolidated*, adjusted basis was reduced by cost of insurance charges because those charges represented the cost of insurance protection that was

enjoyed by the policyholder as the beneficiary of the policy. In contrast, in Situation (2), Brian is wholly unrelated to Allan and did not purchase the life insurance contract for protection against any economic loss upon Allan's death. Brian acquired and held the contract solely with a view to profit and paid additional premiums to prevent the lapse of Brian's purely financial investment, the contract. Situation (2) is thus distinguishable from Rev. Rul. 2009-13 and the authorities cited therein." [Rev. Rul. 2009-14] As the amount realized on Brian's sale of the life insurance contract to Chuck was \$30,000, and the adjusted basis was \$29,000, Brian must recognize \$1,000 on the sale to Chuck. Because the term life insurance contract was not property described in IRC Section 1221(a)(1)-(8) and was held for more than one year, the \$1,000 of gain recognized by Brian upon the sale of the contract to Chuck is long-term capital gain. [IRC §1001; Rev. Rul. 2009-13, 2009-21 IRB 1] Additionally, the contract was a term contract without any cash value. "Hence, the substitute for ordinary income doctrine under *United States v. Midland Ross*, 381 U.S. 54 (1965), and its progeny does not apply." [Rev. Rul. 2009-14]

Situation (3). The facts are the same as in Situation (1), except that the Investor is a foreign corporation that is not engaged in a trade or business within the United States (including the trade or business of purchasing, or taking assignments of, life insurance contracts). As in Situation (1), the Investor must recognize \$71,000 of ordinary income upon the receipt of death benefits. This income is "fixed or determinable annual or periodical" income within the meaning of IRC Section 881(a)(1). [See Treas. Reg. § 1.1441-2(b); Rev. Rul. 64-51, 1964-1 C.B. 322; Rev. Rul. 2004-75, 2004-1 C.B. 516] Consequently, Investor is subject to tax under IRC Section 881(a) with respect to this income, if the income is from sources within the United States.

Interest received from a domestic corporation is generally from sources within the United States. [Section 861(a)(1)] Premiums received from the issuance of any life insurance contract are generally income from sources within the United States when the premiums are derived in connection with a life insurance contract issued in respect of the lives of residents of the United States. [IRC § 861(a)(7)] The source of income from the sale of personal property is generally determined by reference to the residence of the taxpayer. [IRC §865] When the source of an item of income is not specified by statute or by regulation, courts have determined the source of the item by comparison and analogy to classes of income specified within the statute [See *Bank of America v. United States*, 680 F.2d 142, 147 (Ct. Cl. 1982); *Howkins v. Comm'r*, 49 T.C. 689 (1968); *Clayton v. United States*, 33 Fed. Cl. 628 (1995), *aff'd* without published opinion, 91 F.3d 170 (Fed. Cir. 1996), *cert. denied*, 519 U.S. 1040 (1996). See also Rev. Rul. 79-388, 1979-2 C.B. 270]. The Code does not specify the source of income resulting from the payment of death benefits pursuant to a term life insurance contract. [See also Rev. Rul. 2004-75] Consequently, the source of such income is determined by comparison and analogy to classes of income which are specified within the statute. Allan is a United States citizen, residing in the United States; and Insurance Sales is a domestic corporation. Investor's income is from sources within the United States.

Estate Planning Common Mistakes: Misconceptions about estate planning contribute to mistakes made in estate planning. Since 1979, as a fee-paid specialist in estate/gift taxation and planning, this author has yet to review in the initial get-acquainted interview a person's existing Last Will and trust that would carry-out the person's estate plan as intended. Many reasons exist for this truism; yet, the majority of the reasons can be attributed to often-repeated common mistakes. Following are two common mistakes most often made:

Updating. The most frequent mistake people make is not updating their estate plans, Last Wills, trusts, buy-sell agreements, powers of attorney, and so forth. People simply do not realize that their estate plans are dynamic, rather than static. People forget that marriages and divorces; deaths and births; changes of domicile, residencies or jobs; illnesses in families; changes in the tax laws; and other myriad factors influence estate plans. Often, modifications made to estate plans necessitate amendments to existing Last Wills, trusts and business succession documents.

Incorrect Form of Property Ownership. Incorrect form of property ownership in relation to the terms of the estate owner's Last Will and trust agreement can compromise the estate owner's intentions for how the property should pass to intended beneficiaries. Owning property as joint tenants with right of survivorship ("JTWROS"), including tenants by the entirety with right of survivorship or as "husband and wife," is the single most common mistake that causes estate plans of married persons to fail. A Last Will cannot distribute property that is owned by the decedent and another person as JTWROS. Likewise, a trust under a Last Will, or as a separate legal document, cannot be

funded when property is owned by two or more persons as JTWROS. Consequently, the estate tax marital deduction taken in the decedent spouse's gross estate may be more than necessary (overqualified marital deduction) to reduce or eliminate estate tax and state death taxes ("transfer taxes") in relation to the decedent spouse's federal estate tax exemption amount; and the surviving spouse's estate may be subject to unnecessary transfer tax because of too much property received by right of survivorship being included in the surviving spouse's gross estate.

Irrevocable Trust Is Grantor Trust: Not infrequently, the question is asked by both practitioners and taxpayers, "When is an irrevocable living trust a grantor trust?" The answer determines whether the grantor is taxed on the income of the trust. Determining the answer is not always a "slam dunk." The answer must be based on all the facts surrounding the administration of the irrevocable trust and whether the grantor's administrative powers, if any, under the trust are exercisable in a **fiduciary** or **nonfiduciary** capacity. An understanding of IRC Sections 671-678 is essential to determining the correct answer to a given set of facts. For example, suppose Sarah created and funded an irrevocable trust ("Trust") for the benefit of Sarah's children. In accordance with State law, Sarah and all beneficiaries of Trust will execute a modification to Trust's governing instrument to provide that Sarah shall have the power, solely in a **nonfiduciary** capacity and without the approval of any person in a fiduciary capacity, **to reacquire any property contained in Trust by substituting other property of equivalent value.**

In effect, IRC Section 671 provides that, if the grantor is deemed the owner of a trust, whether the trust is revocable or nonrevocable, all items of income, deductions and credits against tax of the trust, to the extent such items would be taken into account in computing taxable income or credits against the tax of an individual, must be included in computing the taxable income and credits of the grantor or other person deemed owner of the trust. Code Sections 673 through 678 specify the circumstances under which the grantor or a person other than the grantor is treated as the owner of a portion of a trust.

The grantor is treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a **nonfiduciary** capacity by any person without the approval or consent of any person in a fiduciary capacity. The term "power of administration" includes a power to **reacquire the trust corpus by substituting other property of an equivalent value.** [IRC §675(4)] Further, the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. [Treas. Reg. §1.675-1(a)] Also, the circumstances that may cause administrative controls to be considered exercisable primarily for the benefit of the grantor include the existence of certain powers of administration exercisable in a **nonfiduciary** capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a **fiduciary** capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a **fiduciary** or a **nonfiduciary** capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration. [Treas. Reg. §1.675-1(b)(4)(iii)] In the example, if the circumstances indicate that the power of administration is exercisable in a **nonfiduciary** capacity, Sarah will be treated as the owner of Trust under IRC Sections 671 and 675 and the income, deductions and credits attributable to such income over which Sarah's power of administration is exercisable will be taken into account in computing Sarah's taxable income, deductions or credits. [Ltr. Rul. 200848006; *see also* Ltr. Ruls. 200848015, 200848016, and 200848017]

Question of the Month: Can property be transferred to the revocable living trust the same day that the trust is effected? **Answer:** Generally, yes. In most cases, tangible personal property (*e.g.*, household furniture and furnishings, wearing apparel, jewelry and personal effects, books, art objects, collections, sporting and recreational equipment, any automobile, and so forth), interests in intangible personal property (*e.g.*, mortgages, trust deeds, contracts, installment obligations, leases, royalties, patents, stocks and bonds, and so forth) and interests in real property can all be transferred to the revocable living trust immediately following execution of the trust agreement. In most cases, legal title to the trustor's interest in bank accounts, credit union accounts, brokerage accounts,

annuities and life insurance policies is transferred to the trustee of a revocable living trust following its execution. Transfer of these assets to the revocable living trust requires the completion of the financial institution's or insurance company's particular forms to effect conveyance of legal title to the trustee, along with a copy of certain pages of the trust agreement. In my book, *Living Trusts: Third Edition, John Wiley & Sons, Inc., Copyright © 2003 by Doug H. Moy*, all rights reserved, see chapter 2, page 69, for discussion regarding the pages of the Trust Agreement to be provided financial institutions. For additional discussion, see chapter 11, Publicly-traded Securities and U.S. Government Obligations; chapter 13, Accounts in Banks, Savings Associations, and Credit unions; and chapter 15, Retirement Plans, Life Insurance, and Annuities.

AFR: The **August 2009** Applicable Federal Rate, under IRC Section 7520, for determining the present value of an annuity, an interest for life or a term of years or a remainder or reversionary interest is **3.4 percent** [Rev. Rul. 2009-22, 2009-31 I.R.B.1, Table 5]. The **September 2009** AFR is **3.4 percent** [Rev. Rul. 2009-29, 2009-37 I.R.B.1, Table 5]. This bodes well for the grantor retained annuity trust (GRAT), charitable lead annuity trust (CLAT), charitable transfer of remainder interest in residence or farm and private annuities but not well for the qualified personal residence trust (QPRT), grantor retained income trust (GRIT) and charitable remainder annuity trust (CRAT). Lower AFRs have no impact on grantor retained unitrust (GRUT), charitable remainder unitrust (CRUT), charitable lead trust (CLT) and pooled income funds. **Note:** In the case of transfers to a CRAT for which the *valuation date* is **after** April 30, 1999, if an election is made under IRC Section 7520 and Treasury Regulation Section 1.7520-2(b) to compute the present value of the charitable interest by use of the interest rate component for **either of the two months preceding the month** in which the transfer is made, the month so selected is the *valuation date* for purposes of determining the interest rate (*i.e.*, the AFR) and mortality tables [Treas. Reg. § 1.664-2(c) (Jan. 5, 2001)]. In other words, one may choose the lowest AFR of either of the two months preceding the month the CRAT is funded in order to obtain the maximum tax deduction for the present value of the remainder interest.

[**Note:** Section 6110(k)(3) of the Code provides that letter rulings may not be used or cited as precedent; however, they may be cited as authority].

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Available by order at most book stores for \$39.95: Moy, Doug H., *Living Trusts, Third Edition*. John Wiley & Sons, Inc., 2003. Or visit www.wiley.com. In the upper right-hand corner, enter: Doug Moy (and then click on "Search").

This is an extremely accessible work, written in a clear, conversational tone....This is a very commendable work, equally appropriate in the professional's office library or at home on the den bookshelf.... Highly recommended.
Nancy Shurtz, *Estate Planning*, July 2004, Vol. 31/No.7, p. 357.

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