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ESTATE WISE PLANNING™

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Surrender or Sale of Life Insurance Contracts. Guidance has been issued by the IRS regarding the surrender or sale of individual life insurance contracts [Rev. Rul. 2009-13, 2009-21 IRB 1. Under the authority of IRC §7805(b)(8), the holdings of this revenue ruling with respect to Situations 2 and 3 will not be applied adversely to sales occurring before August 26, 2009]. This guidance involves three situations:

Situation (1): Surrender of life insurance policy. On January 1 of year 1, Ed, the insured, purchased a cash value life insurance policy and named a family member beneficiary. Ed had the right to change the beneficiary, take out a policy loan or surrender the contract for its cash surrender value; in other words, Ed retained *incidents of ownership* in the policy. The contract in Ed's hands was not "capital asset" property as defined in IRC Section 1221(a)(1)-(8). On June 15 of year 8, Ed surrendered the policy for its \$78,000 cash surrender value, which reflected the subtraction of \$10,000 of "cost-of-insurance" charges collected by the insurer for periods ending on or before the surrender of the contract. Through that date, Ed had paid premiums totaling \$64,000 on the life insurance policy. Ed had neither received any distributions under the policy nor borrowed against the cash surrender value of the policy. Ed determines taxable income using the cash method of accounting and files income tax returns on a calendar year basis. As of June 15 of year 8, Ed was not a terminally ill individual nor a chronically ill individual within the meaning of IRC Section 101(g)(4). Accordingly, \$14,000 [\$78,000 (net cash surrender value) less \$64,000 (premiums paid) equals \$14,000] of income recognized by Ed on the surrender of the life insurance policy is ordinary income.

Situation (2): Sale of life insurance policy. The facts are the same as in Situation (1), except that on June 15 of year 8, Ed sold the life insurance policy for \$80,000 to Sam, a person unrelated to Ed and who would suffer no economic loss upon Ed's death. Ed paid total premiums of \$64,000 for the life insurance policy through the date of sale, and \$10,000 was subtracted from the policy's cash surrender value as cost-of-insurance charges. Accordingly, Ed's adjusted basis in the policy as of the date of sale was \$54,000 [\$64,000 (premiums paid) less \$10,000 expended as cost of insurance]. Accordingly, Ed must recognize \$26,000 on the sale of the life insurance policy to Sam, which is the excess of the amount realized on the sale (\$80,000) over Ed's adjusted basis of the policy (\$54,000).

Unlike Situation 1, which involves the surrender of the life insurance contract to the insurer of the policy, Situation 2 involves an actual sale of the contract. Nevertheless, some or all of the gain on the sale of the policy may be ordinary, if the substitute for ordinary income doctrine applies. The Supreme Court has held, under the so-called "substitute for ordinary income" doctrine, that "property" within the meaning of IRC Section 1221 does not include claims or rights to ordinary income. Instead, the Court "has consistently construed 'capital asset' to exclude property

representing income items or accretions to the value of a capital asset themselves properly attributable to income” [*United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965)]. See also *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (consideration received on the sale of a working interest in an oil well represented a substitute for what would have been received in the future as ordinary income, therefore taxable as ordinary income and not capital gain); *Arkansas Best Corp. v. Comm’r*, 485 U.S. 212, 217, n.5 (1988) (noting that the “substitute for ordinary income” doctrine had no application to that case)]. Thus, ordinary income that has been earned but not recognized by a taxpayer cannot be converted into capital gain by a sale or exchange [See also *Prebola v. Comm’r*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004); *Davis v. Comm’r*, 119 T.C. 1 (2002) (applying the “substitute for ordinary income” doctrine after the *Arkansas Best* decision)].

The “substitute for ordinary income” doctrine has been applied to characterize the profit on a sale of an annuity contract or life insurance contract as ordinary income [*Gallun v. Comm’r*, 327 F.2d 809, 811 (7th Cir. 1964)]. Application of the “substitute for ordinary income” doctrine is limited to the amount that would be recognized as ordinary income if the policy were surrendered (*i.e.*, to the inside build-up under the policy). Hence, if the income recognized on the sale or exchange of a life insurance policy exceeds the “inside build-up” under the policy, the excess may qualify as gain from the sale or exchange of a capital asset [See, *e.g.*, *Commissioner v. Phillips*, 275 F.2d 33, 36 n. 3 (4th Cir. 1960)]. In Situation 2, the inside build-up under Ed’s life insurance policy immediately prior to the sale to Sam was \$14,000 (\$78,000 cash surrender value less \$64,000 aggregate premiums paid). Hence, \$14,000 of the \$26,000 of income that Ed must recognize on the sale of the policy is ordinary income under the “substitute for ordinary income” doctrine. Because the life insurance policy in Ed’s hands was not property described in IRC Sec. 1221(a)(1)-(8) and was held by Ed for more than one year, the remaining \$12,000 of income is long-term capital gain within the meaning of IRC Section 1222(3).

Situation (3): Sale of level-premium term life insurance policy. The facts are the same as in Situation 1, except that the policy was a **level premium fifteen-year term life insurance contract** without cash surrender value. The monthly premium for the contract was \$500. Through June 15 of year 8, Ed paid premiums totaling \$45,000 for the policy. On June 15 of year 8, Ed sold the life insurance policy for \$20,000 to Bob, a person unrelated to Ed and who would suffer no economic loss upon Ed’s death. The amount realized from the sale is the sum of money received from the sale, or \$20,000. Ed’s adjusted basis in the life insurance policy is equal to the total premiums paid, less charges for the insurance before the sale. Absent other proof, the cost of the insurance provided to Ed each month is presumed to equal the monthly premium under the policy, or \$500. The cost of the insurance protection provided to Ed during the 89.5 month period that Ed held the policy was \$500 times 89.5 months, or \$44,750. Hence, Ed’s adjusted basis in the policy on the date of the sale to Bob was \$250 (\$45,000 total premiums paid, less \$44,750 cost of insurance protection). Accordingly, Ed must recognize \$19,750 on the sale of the term life insurance policy to Bob, which is the excess of the amount realized on the sale (\$20,000) over the adjusted basis of the policy (\$250).

Since the term life insurance policy had no cash surrender value, there was no inside buildup under the policy to which the substitute for ordinary income doctrine could apply. Because the policy in Ed’s hands was not property described in IRC Section 1221(a)(1)-(8) and was held by Ed for more than one year, the \$19,750 of income that Ed must recognize on the sale of the policy is long-term capital gain within the meaning of IRC Section 1222(3).

Misconceptions About Estate Planning: Many estate owners do not understand the process of estate planning. This is due in large part to the inability of the practitioner to communicate to the estate owner exactly what is involved in the estate planning process. Further, because estate planning involves more than just effecting a Last Will or trust, many estate owners have misconceptions about estate planning. These misconceptions, when not addressed by practitioners, are some of the primary reasons why so many so-called estate plans fail to operate as the estate owners intended.

Last Will and Trust Are an Estate Plan. One misconception is that a Last Will and trust constitute an estate plan. These legal documents only carry-out the decedent’s estate plan, if a plan has been formulated. Unless the practitioner conducts a thorough fact-finding interview and designs a formal, written estate plan based on the estate owner’s goals and objectives, the resulting estate plan will look much like a Rube Goldberg cartoon—the end result achieved solely by chance.

Probate and Taxes Are Related. Another misconception is that, if estate taxes are not imposed on an estate, probate of the estate is unnecessary. Of course, transfer taxes and probate have absolutely nothing to do with one another. They are completely unrelated matters. On the one hand, as a general rule, if estate taxes are due, property comprising the *probate estate* may not be released from the probate process to be distributed by the personal representative (or administrator, if the decedent dies intestate) to those beneficiaries (or heirs) of the decedent entitled to receive such property until the taxes are paid or arrangements have been made to pay the taxes. On the other hand, an estate may be subject to probate when income or transfer taxes are not imposed.

Having a Last Will Eliminates Probate. Many people also operate under the misconception that, if a person has a Last Will, probate is unnecessary. Having a Last Will does not guarantee that probate can be avoided. The truth is that a person's estate may be probated whether or not a Last Will is involved. If the decedent's estate contains *probate estate* property, probate may be required. Generally, the value of such property determines whether a formal probate proceeding is required or if the property can be administered under a state's small estate statute.

Probate Is Determined by Federal Estate Tax Exemption Amount. A fourth misconception is that, if the value of a person's estate is less than the federal estate tax exemption amount (currently, \$3.5 million), probate is unnecessary. The federal estate tax exemption amount relates to federal estate tax; it has nothing to do with whether a decedent's estate is required to be probated. Also, the federal estate tax exemption amount should not be used as a guide to determine whether a person's estate is large enough to warrant the use of a revocable living trust. The use of a revocable living trust should not be determined by the value for federal estate tax purposes of a person's estate.

Artwork Discount: The decedent's estate sought a 44 percent fractional-interest discount, which was proposed by the estate's appraiser, Carsten Hoffman. The district court found that the estate was entitled to claim a 5 percent fractional-interest discount when valuing its undivided 50 percent interest in a nineteen-painting art collection. The 9th Circuit Court of Appeals affirmed the District Courts 5 percent discount [*Robert Grove Stone v. United States*, No. 07-17068 (9th Cir. 2009)]. This disposition is not appropriate for publication and is not precedent except as provided by 9th Cir. R. 36-3]. If nothing else, this case is illustrative of the need for convincing evidence and the employ of an appraiser qualified to appraise the asset to be valued, both prerequisites of which were absent in *Stone*. Treasury Regulation Section 20.2031-1(b) requires the government to value a fractional interest at the price on which a hypothetical willing buyer and willing seller would agree, and this may often reflect a discount based on fractional ownership [*See Propstra v. United States*, 680 F.2d 1248, 1251 (9th Cir. 1982)]. But the taxpayer still bears the burden of proof. In *Stone*, the court simply concluded that the **evidence offered by the estate** was neither probative nor convincing. In opting not to credit Hoffmann's report and testimony, the district court cited, *inter alia*, Hoffmann's total lack of experience with the art market; the dissimilar motives driving purchasers to acquire art, on one hand, and real estate or limited-partnership shares from the estate, on the other; and the unreasonably low appreciation rate and unreasonably high present-value discount rates Hoffmann used in his cost-of-partition analysis. The 9th Circuit could not say the district court clearly erred in adopting the government's 5 percent discount rate and rejecting the Estate's discount.

Valuation of Lottery Payments: The appropriate valuation method to determine the value of a decedent's lottery payments as an asset in the gross estate is frequently challenged. A recent case boiled down to whether the IRS used an appropriate discount rate when calculating the present value of the decedents' remaining lottery payments [*Carol Negron v. United States*, No. 07-4460 (6th Cir. 2009), *rev'g and remanding* 1:05-cv-02305 (D.C. N.D. Ohio, June 4, 2007)]. Negron, Executrix, for the estates of decedents Mary S. Susteric and Mildred Lopatkovich argued that it is unreasonable that the estates were taxed on a distribution amount in excess of that received. This concern translated into allegations that the IRS annuity tables did not properly take into account marketability restrictions on the lottery annuity and, thus, did not provide a reasonable assessment of its fair market value. The district court determined that departure from the annuity tables provided by IRC Section 7520 and Treasury Regulation Section 20.2031-7 (the "IRS annuity tables") was warranted when Negron could show that "(1) the value ascribed by the tables is unrealistic and unreasonable; and (2) there is a more reasonable and realistic means by which to determine its fair market value." Then, it found that "transferability of an annuity would affect its fair market value" and that "the value ascribed by the annuity tables for both estate taxes [was] unrealistic and unreasonable."

Each estate was required to include the value of the remaining lottery payments on its estate tax return [IRC §§ 2001, 2031, 2039, 2051]. Negron reported the value as \$2,275,867 on each return based upon the amount that each estate received from the Ohio Lottery Commission. The Commission calculated the distribution—the present value of the remaining lottery payments—using a discount rate of 9.0 percent from the state valuation tables in effect on January 19, 1991, the date the lottery prize was won. The IRS determined that the proper values of the remaining lottery payments were \$2,775,209 for Lopatkovich and \$2,668,118 for Susteric. It used discount rates of 5.0 percent for Lopatkovich and 5.6 percent for Susteric from the IRS annuity tables in effect on the dates of death to calculate the present value of the remaining payments [IRC §7520; Treas. Reg. §§ 20.2031-7(d), 20.7520-1]. The IRS assessed an additional tax of \$330,302 for Lopatkovich and \$141,175 for Susteric. Both estates paid the additional tax, with interest, and filed refund claims. The IRS denied both claims, and the estates filed suit in the district court for a refund. In sum, the 6th Circuit held that the IRS properly used the IRS annuity tables to value the remaining lottery payments for estate tax purposes. The tables do not result in an unrealistic or unreasonable valuation, and departure from the tables is not justified or required. Hence, the 6th Circuit reversed and remanded to the District Court for proceedings consistent with the 6th Circuit’s opinion.

In reaching its opinion, the 6th Circuit noted that,

...the district court incorrectly reasoned that the IRS annuity tables produced an unrealistic and unreasonable result because the transfer restrictions would affect fair market value. The overarching goal of the Internal Revenue Code is to impose a tax on the value of all of the decedent’s property, to the extent of the decedent’s interest, at the time of death [IRC §§ 2031, 2033]. The Treasury Regulations generally provide that the value of every item of property is its fair market value and that the fair market value of an annuity is its present value using the IRS annuity tables [Treas. Reg. §§ 20.2031-1(b), -7(d)]. We agree with the Fifth Circuit that the non-marketability of annuities is an assumption underlying the IRS annuity tables [See *Cook v. Commissioner*, 349 F.3d 850, 856 (5th Cir. 2003) (providing a list of other annuities with marketability restrictions that are valued using the IRS annuity tables)]. The property right at issue is a legally enforceable, virtually risk-free right to receive annual payments that cannot be assigned to a third party [See *Davis v. United States*, 491 F. Supp. 2d 192, 196 (D.N.H. 2007)]. A marketability factor is not necessary to determine the value of a guaranteed income stream; the value of the decedent’s interest at the time of death is readily ascertainable and fairly reflected by the present value of the remaining payments using the IRS annuity tables in effect on the date of death [See *Cook*, 349 F.3d at 857].

Question of the Month: Is transferring property to a revocable living trust a complicated process?

Answer: As a general rule, the process of transferring property to a revocable living trust is not complicated. To date, this author can count on one hand the number of instances where transferring a particular asset to a revocable living trust was more difficult than initially anticipated. However, it must be said that, unlike before 9/11, retitling bank accounts in the name of the trustee seems to have become more challenging—but not impossible. The challenge has been created by a combination of inadequately trained bank personnel responsible for the retitling process, together with burdensome software programs used by banks to effect such retitling. In my book, *Living Trusts: Third Edition, John Wiley & Sons, Inc., Copyright © 2003 by Doug H. Moy*, all rights reserved, chapter 13 provides needed information for titling, in the name of the trustee of a revocable living trust, accounts in banks, savings associations and credit unions.

AFR: The **July 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. 2009-20, 2009-28 I.R.B.1, Table 5]. The **August 2009** AFR is **3.4 percent** [Rev. Rul. 2009-22, 2009-31 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").

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Nancy Shurtz, *Estate Planning*, July 2004, Vol. 31/No.7, p. 357.

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