



Avoiding the “3-Year Rule” for Transfer of an Existing Life Insurance Policy

Question: Are there strategies for avoiding or minimizing the application of the three-year rule in the situation where an insured desires to transfer a policy he/she owns to a life insurance trust? Are all transfers of life insurance policies within three years of the insured’s death subject to the three-year rule of estate inclusion under Internal Revenue Code Section 2035?

Answer: Today, with proper structuring, an insured can arrange for the purchase of a policy on his/her life without triggering estate tax inclusion of the policy proceeds. We are often confronted with the situation where an individual has purchased a policy on his/her life and retained an “incident of ownership” causing the proceeds to be included in his/her gross estate. Fortunately, there are strategies to undo this error. Before identifying strategies to undo or minimize application of the three-year rule, it’s first helpful to have a general understanding of the rule.

Background on Section 2035 Transfer Within Three Years Rule. Prior to the Economic Recovery Tax Act of 1981 (ERTA) section 2035 generally required that all gifts made within three

years of death be pulled back into the donor’s gross estate.¹ ERTA repealed the three-year pullback rule, except for certain narrowly defined transactions. One of the narrowly defined areas where the three-year rule continues to apply is transfers of life insurance.

Application of the three-year rule to transfers of life insurance was initially clouded in controversy. However, as a result of litigation over the last several years, the application of the three-year rule to transfers of life insurance is now clear in most situations. Today, the consensus is that section 2035 requires that life

¹ *It’s not unusual to hear the three-year rule referred to as the “contemplation of death” rule. The contemplation of death rule preceded the three-year rule. It generally required that all gifts made in contemplation of a donor’s death be included in the donor’s gross estate. Under this rule, gifts made within three years of a donor’s death were presumed to be made in contemplation of death, but the presumption could be rebutted. Because the factual nature of the contemplation of death test led to considerable litigation, the test was eliminated by the Tax Reform Act of 1976 and replaced with the more definitive three-year test.*

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insurance proceeds be included in a decedent's gross estate only where:

- ◆ The policy is on the decedent's life and decedent had a power or interest in the life insurance within the meaning of section 2042 (policy is payable to, or for the benefit of, the insured's estate, or the insured had an "incident of ownership" in the policy) at some time during the three-year time period before his/her death;
- ◆ There was a transfer of an interest in the policy within three years of the decedent's death; and
- ◆ The transfer was for less than full and adequate consideration in money or money's worth.

Transfers Not Subject to Section 2035. It's clear that a life insurance policy is includable in a decedent's gross estate under section 2035 only if the policy would have been included under section 2042. As long as the policy is not payable to or for the benefit of the estate, section 2035 requires that the decedent have an incident of ownership in a policy on his/her life within three years prior to death in order for the three-year rule to apply. Consequently, if a decedent transfers a policy that he/she owns on the life of another and dies within three years of the transfer, neither the cash value or death proceeds are included in the decedent's estate.

Likewise, if someone other than the decedent/insured owns the policy, the proceeds are excluded from the insured's estate even if the insured makes a cash gift to the owner who uses the cash to purchase a life insurance policy.

Where an individual with a taxable estate possesses "incidents of ownership" in a policy on his/her life there are basically two alternatives for removing the policy from the estate – to sell the policy or to gift it away. Each strategy has its issues. Let's take a closer look.

Gifting an Existing Life Insurance Policy to a Third Party. It's clear that if an individual gifts a policy he/she owns on his or her life and continues to pay premiums, and dies within three years of the transfer, the full death proceeds will be included in the insured's gross estate. In this situation, it may be possible to exclude a proportionate share of the proceeds included in the insured's gross estate if the donee (the third-party recipient) pays some of the premiums out of his/her own separate funds after the transfer. The portion excluded bears the same relationship to the total policy proceeds as the premiums paid by the donee bears to the total premiums paid.² Thus, one strategy to lessen application of the three-year rule is to have the donee pay the premiums after the transfer.

In general, if the decedent/insured outlives the three-year pullback period and has divested himself/herself of all rights, powers or interests in the policy, none of the proceeds will be includable in his/her gross estate under section 2035. That is true regardless of whether the insured continued to pay the premiums or the donee paid the premiums after the gift. As long as the insured lives for more than three years after the transfer, the proceeds will not be included in the insured's gross estate even if the transferee changes the original policy for a new policy or renews an annually renewable term policy and the insured dies within three years of the issuance/renewal of the new policy.

Be aware – there are numerous instances that can lead to estate inclusion of the proceeds of a policy that has been transferred to an ILIT under other sections of the Internal Revenue Code. Inclusion may result when the insured transfers an existing policy insuring his/her life to an ILIT in which he/she serves as the trustee or retains

² *Estate of Silverman*, 61 T.C. 338 (1973); *Estate of Friedberg v. Commission*, T.C. Memo 310 (1992). See also PLR 9128008.

certain proscribed interests in the policy (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, to obtain a loan from the insurer, etc.). Inclusion may also occur when the insured is a power holder with respect to trust property. This is clearly an area where legal counsel should be consulted.

Selling an Existing Life Insurance Policy to a Third Party. The three-year pullback rule does not apply to a “bona fide sale for adequate and full consideration in money or money’s worth.”³ This exception presents an opportunity for selling an existing life insurance policy to avoid the three-year rule of IRC § 2035. However, unless a policy is sold for an amount at least equal to the policy’s fair market value, the transaction will fail to meet the “bona fide” sale exception, resulting in estate inclusion under IRC § 2035 if the insured dies within three years. The problem: What constitutes adequate and full consideration?

In general, for gift tax purposes, the regulations provide that the value of an unmatured life insurance policy that has been in force for some time and on which premiums are still being paid is the interpolated terminal reserve plus unearned premium.⁴ However, because the rationale for the three-year pullback rule is different than the rationale for imposing gift tax, it does not necessarily follow that the gift tax regulations will be used when reviewing the adequacy of consideration for the “bona fide sale” exception for estate tax purposes. There are no cases on point, and the IRS’s position in private letter rulings has been inconsistent.

In Technical Advice Memoranda (TAM) 8806004, where the insured’s controlled corporation transferred policy ownership to

the insured’s two sons and an irrevocable trust, the IRS held that consideration paid for a policy is not adequate for purposes of the three-year rule, unless it is equal to the face amount of the policy.

TAM 8806004 relied heavily on *United States v. Allen*, which held that the sale of a retained life estate (the remainder interest having been previously transferred gratuitously) for its gift tax value under the IRS’s tables did not constitute adequate and full consideration.⁵ The majority of commentators feel that this “retained interest” valuation rationale is inappropriate when valuing the outright sale of a life insurance policy.

In a more recent letter ruling, where a husband and wife created a new trust that purchased joint survivor policies from two pre-existing trusts for an amount equal to the interpolated terminal reserve plus unearned premium (the gift tax value), the IRS concluded that the purchase of the policies was for adequate and full consideration and met the bona fide sale exception.⁶

Once again, in private letter ruling (PLR) 199905010, where a corporation sold a policy it owned on the majority shareholder to his children for “the greater of its interpolated terminal reserve value or its cash value,” the IRS concluded that the transfer met the adequate and full consideration standard for purposes of the bona fide sale exception.

Thus, the most recent position of the IRS appears to acknowledge that the *Allen* rationale is not applicable to the sale of a life insurance policy. However, it should be noted that the gift tax value of a policy might not be determinative of its fair market value under all circumstances.

³ IRC § 2035(d); Treas. Reg. § 20.2035-1(e)

⁴ Reg. § 25.2512-6(a).

⁵ *United States v. Allen*, 293 F.2d 916, (10th Cir. 1961).

⁶ TAM 9413045

In *Estate of Pritchard v. Commissioner*, 4 TC 204 (1944), the Tax Court held that the normal valuation rules of a life insurance policy for gift tax purposes do not apply if the insured is nearing death. In *Pritchard*, the insured sold policies on his life to his wife for their cash surrender value. At the time of the sale the insured was in danger of imminent death. The Tax Court determined that the sale failed to satisfy the adequate and full consideration test. The Court held that the value of the policies approached their face value. In PLR 9413045 the IRS did note that the insureds requesting the ruling were not in danger of imminent death; however, the ruling did not resolve the question, When are the regulations determining gift tax value of life insurance policies no longer dispositive as to a policy's fair market value?

Other challenges present themselves even if the taxpayer manages to avoid the hurdle of "full consideration."

First, to accomplish the sale to the trust, the trust must have sufficient funds for the purchase. Where the trust lacks income-producing assets, the trust will need to be seeded through annual gifts and/or by the use of the gift tax applicable exclusion amount. This can be an obstacle when time is of the essence. Where the insured transfers the cash used by the trustee to purchase the policy, the IRS could apply the step transaction rule. Due to the transfer and the subsequent return of the cash used to purchase the policy, the insured is left in the same position the insured would have been in had the policy been transferred to the trust for no consideration. Many commentators believe that to reduce the risk of the application of the step transaction rule, it would be preferable if there were either a substantial time lapse between the transfer of contributions and the subsequent purchase or that someone other than the insured transferred the necessary contributions to the trust.

Second, although transfers for "full and adequate consideration" are excepted from the three-year pullback rule, transferring a life insurance policy for consideration can subject the policy to another tax dilemma, that is, the transfer-for-value rule.⁷ Under IRC § 101, life insurance proceeds are exempt from income taxation to the recipient. However, if a life insurance policy is transferred in exchange for any form of valuable consideration, the death benefit proceeds in excess of the consideration paid and the premiums or other amounts subsequently paid by the transferee will be subject to income tax.⁸

Fortunately, there are exceptions to the transfer-for-value rule. It is important to pair the sale to the ILIT with one of these exceptions to reduce the risk of unwanted tax consequences.

The following is a discussion of some of the more common strategies used to reduce the risk that the transfer-for-value rule will be imposed when transferring an existing policy to an ILIT. (For more information on the transfer-for-value rule and its exceptions, see Prudential Financial's *Frequently Asked Questions IFS-A005036 The Transfer-For-Value Rules: Application to Term Insurance & to a Policy Subject to a Loan.*)

◆ **Transfer to the Insured.** Most ILITs are drafted as grantor trusts, where the insured is treated as the owner for income tax purposes.⁹ Since a sale to the insured is excepted from the transfer-for-value rule, it may be possible to argue that the sale of the policy to the grantor trust can be considered a sale to the insured.

Until recently the only authority that supported this position was *Swanson v. Commissioner* and a series of private letter

⁷ IRC §101(a)

⁸ IRC §101(a)(2)

⁹ IRC §671-677

rulings.¹⁰ However, in 2007, the IRS issued Revenue Ruling 2007-13, which involved two fact patterns. The first fact pattern involved a transfer of a life insurance policy between two grantor trusts, each of which was treated as being wholly owned by the grantor. The second fact pattern involved a transfer from a nongrantor trust to a second trust, which was a grantor trust.

In the first fact pattern the IRS held that a grantor would be treated as the owner of a life insurance policy on his life when the policy is owned by a grantor trust of which the grantor is treated as owner. Accordingly, because the insured was merely transferring the policy to himself/herself, the transfer-for-value rule does not apply since there was no change of ownership.

In the second situation, since the policy was transferred from a nongrantor trust to a grantor trust, the transaction was treated as a transfer for valuable consideration within the meaning of the transfer-for-value rules. Here again, the IRS held that an exception to the transfer-for-value rule applied because the transfer to the grantor trust was deemed to be a transfer to the insured.

- ◆ **Sale to a Partner of the Insured.** Using this strategy, the grantor/insured creates an ILIT. The insured then seeds the trust with cash or income producing assets. The ILIT trustee then transfers a portion of the trust's principal in exchange for an interest in a partnership in which the insured is a partner. Following this capital transfer, the ILIT/partner purchases the existing policy from the insured. To avoid the IRS assertion that the partnership should be disregarded,

the new partnership should have more than minimal funding and be operated as a viable partnership with a business purpose and the trust should be more than a nominal partner.

- ◆ **Sale to a Partnership.** This strategy essentially substitutes the partnership/ family limited partnership (FLP) for the ILIT. Be aware that when using the FLP as an ILIT alternative it takes careful planning with advisors to achieve the desired result of estate-tax-free proceeds.

The difficulty in using an FLP in place of an ILIT stems from the lack of regulations dealing with the incidents of ownership held by a partner through a partnership. Furthermore, the IRS has not been consistent in its analysis of the issue – switching between the entity and aggregate theories of partnership law. Many commentators believe that in light of the most recent rulings, caution dictates that when structuring within the partnership exception, the policies should represent less than 50% of the partnership assets, the partnership should have an independent business purpose, and the partnership agreement should prohibit a general partner from exercising any incidents of ownership over his/her policy. (For a discussion of using an FLP as an ILIT alternative, see Prudential Financial's *Frequently Asked Questions IFS-A077810 An Alternative to an ILIT – Life Insurance in a Partnership*).

Summary. The transfer within three-year rule, transfer-for-value rule, and the incidents-of-ownership rule can present hurdles in situations where an individual has purchased a policy on his/her life and retained ownership causing it to be includable in the gross estate. Fortunately, strategies exist for undoing the error.

¹⁰ *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975). See PLRs 200228019, 200247006, 200514001, 200514002, 200518061, 200606027 and 200636086.