

INTERNAL REVENUE SERVICE

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DECEMBER 15, 2000

Legend

Limited Partnership =

Grantor 1 =

Grantor 2 =

Trust 1 =

Trust 2 =

Child 1 =

Child 2 =

Child 3 =

Trust 2 Independent Trustee =

State A =

Date 1 =

Date 2 =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

o =

p =

q =

Dear

This is in response to your June 26, 2000 letter, submitted on behalf of a limited partnership and the grantors of a trust, requesting certain rulings. The requested rulings are that (1) the transfer of a life insurance policy by a trust to a limited partnership will not constitute a "transfer for value" under §101 of the Internal Revenue Code and (2) the transaction will not result in the grantors of the trust possessing incidents of ownership under §2042(2) in the insurance contract by virtue of the grantors' limited partnership interest in the limited partnership. Additional information was submitted in your October 27, 2000 letter.

Facts

On Date 1, Grantor 1 and his wife, Grantor 2 (the Grantors), established Trust 1, in accordance with the laws of State A, to hold property in trust for the benefit of Grantor 1's parents and Grantors' issue. The Grantors have three adult children, Child 1, Child 2 and Child 3. Included in Trust 1's assets are three life insurance policies on the joint lives of Grantor 1 and Grantor 2. Each policy has a face amount of \$b. Two of the three policies in Trust 1 (the Acquired Policies) will have an aggregate net surrender value of approximately \$c at the time they are contributed as described below. It is represented that each of the (two) Acquired Policies to be transferred satisfies the requirements of §7702(a) of the Code. Trust 1 owns non-insurance assets in excess of \$b.

Trust 1 provides that, until the death of the last to die of Grantors, the Trust 1 Trustees have discretionary authority to distribute income in equal or unequal shares to or among the Grantor 1's parents and Grantors' children (and the issue of any deceased child of Grantors) for their medical care, comfortable maintenance, support, general welfare, and education, or for certain other purposes, and any income not so distributed shall be accumulated and added to principal. Trust 1 also provides that the Trust 1 Trustees have discretionary authority to distribute such sums from the principal of Trust 1 to or for the above mentioned beneficiaries as the Trustees shall determine.

Trust 1 provides that, upon the death of the survivor of Grantors, if Grantor 1's mother or father (or both) are living, the Trust 1 Trustees shall have discretionary authority to distribute income in equal or unequal shares to Grantor 1's parents for their comfortable maintenance, general welfare and medical care, or for certain other purposes. The Trust 1 Trustees shall have discretionary authority to distribute any remaining income in equal or unequal shares to or among Grantors' children (and the issue of any deceased child of Grantors) for their medical care, comfortable maintenance, general welfare, and education, or for certain other purposes, and that any income not so distributed shall be accumulated and added to principal.

Trust 1 provides that, upon the death of the survivor of both Grantors and Grantor 1's parents, all of the trust property shall be divided into equal shares, one for each then living child of Grantors and one for each child of Grantors who is then deceased but has left surviving issue. It is further provided that the Trust 1 Trustees

shall have the discretionary authority to distribute income to said beneficiaries in such amounts as they determine.

Trust 1 provides for mandatory distributions of the principal of each child's or issue of a deceased child's separate share as follows: d at the time such child or issue attains the age of e; f at the time such child or issue attains the age of g; and the remainder at the time such child or issue attains the age of h.

The Trust 1 Trustees have discretionary authority to retain, for such period as they may determine, any property constituting a part of Trust 1 property and to carry on any business in which any trust established under the governing instrument may have an interest. The Trust 1 Trustees also have discretionary authority to invest and reinvest Trust 1 property in any property, including business and partnership interests. Child 1 and Child 2 were initially designated as the Trust 1 Trustees and are currently serving in that capacity.

On Date 2, Grantors created Trust 2 in accordance with the laws of State A. Trust 2 holds cash and/or marketable securities. It is intended that Trust 2 will have an inclusion ratio of zero for generation-skipping transfer (GST) tax purposes. To the extent that Trust 2 is funded with assets in excess of Grantors' GST Exemptions, the Trust 2 Trustee have the discretion to divide Trust 2 into an Exempt Trust and a Non-Exempt Trust. (For purposes of this letter, the term Trust 2 Trustee is referred to in the singular, however, the term represents both the Family Trustees, who are Child 1, Child 2 and Child 3 as well as the Trust 2 Independent Trustee, who is an attorney.) The Exempt Trust is to have an inclusion of ratio of zero, and the Non-Exempt Trust is to have an inclusion ratio of one.

During either Grantor's life, Trust 2 gives the Trust 2 Trustee the discretionary power to distribute trust income and principal in such equal or unequal amounts as the Trustee shall determine to or among Grantors' children and any issue of such children, provided that any undistributed income is added to principal.

Upon the death of the surviving Grantor, Trust 2 requires the Trust 2 Trustee to divide the property of the Exempt Trust into separate equal shares, one for each child of the Grantors who is then living and one for each child of the Grantors who is then deceased but has issue then living. Following such division, Trust 2 further requires that each separate share be held as a continuing trust. The permissible beneficiaries of each separate trust are the child for whom such division was made ("Primary GST Beneficiary") and the Primary GST Beneficiary's issue. The Trustee of each separate trust is permitted, but not required, to distribute the income and principal of such trust in such amounts and at such times or intervals as the Trustee shall determine to or among the Primary GST Beneficiary and his or her issue, and shall accumulate and add to principal any income not distributed.

Upon attaining the age of e years, each Primary GST Beneficiary has the testamentary limited power to appoint his or her share to one or more of Grantors' issue

or the spouses of Grantors' issue. Further, upon attaining the age of e years, each Primary GST Beneficiary has the lifetime right to withdraw or appoint to any issue of Grantors, including himself or herself, such amounts of income and/or principal as necessary for said issue's medical care, education, support and maintenance in reasonable comfort.

Upon the death of a Primary GST Beneficiary, his or her share is to be divided into equal shares for his or her issue, and each issue's share is to be continued in trust and held pursuant to the terms of Trust 2. The property of the Exempt Trust is to be continued in separate trusts in this manner until the expiration of the perpetuities period.

Regarding the Non-Exempt Trust, Trust 2 requires the Trust 2 Trustee to divide the property of the Non-Exempt Trust into separate equal shares, one for each child who is then living and one for each child who is then deceased but has issue then living. The permissible beneficiaries of each separate trust are the child or an issue of a deceased child for whom such division was made ("Primary Non-GST Beneficiary") and the Primary Non-GST Beneficiary's issue. The trustee of each separate trust is permitted, but not required, to distribute the income and principal of such trust in such amounts and at such times or intervals as the trustees shall determine to or among the Primary Non-GST Beneficiary and his or her issue, and shall accumulate and add to principal any income not distributed.

Upon attaining the age of e years, each Primary Non-GST Beneficiary shall have the testamentary limited power to appoint his or her share to one or more of Grantors' issue or the spouses of Grantors' issue. Further, each Primary Non-GST Beneficiary is entitled to receive d of his or her share upon attaining the age of e years, f of the remaining balance upon attaining the age of g years, and the entire remaining balance upon attaining the age of h years.

Trust 2 provides that following the death of the surviving Grantor, each separate trust established under the governing instrument shall have at least one independent (non-Family) trustee.

The Trust 2 Trustee has the discretionary authority to retain, for such period as they may determine, any property constituting a part of the trust estate, to carry on any business in which any trust established under Trust 2 may have an interest, and to invest and reinvest in any real or personal property.

On Date 2, Grantor 1, Grantor 2, Trust 1 and Trust 2 formed Limited Partnership, a limited partnership (Limited Partnership) in accordance with the laws of State A by executing a limited partnership agreement. Trust 1 will contribute the Acquired Policies to Limited Partnership and, in return, will receive a i% limited partnership interest in Limited Partnership. Trust 2 will contribute \$j in cash to Limited Partnership and, in return, will receive a k% general partnership interest. Grantor 1 and Grantor 2 will each contribute \$c in cash to Limited Partnership and, in return, will each receive a i% limited partnership interest.

The general purpose of Limited Partnership is to acquire, hold, invest in, trade, sell and otherwise deal with real and personal, tangible and intangible property of any nature, including without limitation insurance policies. Under the limited partnership agreement, for each taxable year of the partnership, all taxable income and losses of the partnership will be allocated to the partners pro rata in accordance with their percentage interests, and each distribution by the partnership will be made in accordance with the percentage interests of the partners. Additionally, under the limited partnership agreement, the general partner will have exclusive control over the management and investment decisions of the partnership. The limited partners will have no right to participate in management or investment decisions or to withdraw from the partnership. Further, Limited Partnership will not elect to be treated as other than its default federal tax classification under §301.7701-3(c)(1) of the Procedure and Administration Regulations.

As described above, Trust 1 will contribute the Acquired Policies to Limited Partnership in exchange for a 1% limited partnership interest. As a result, all of Trust 1's right, title and interest in the Acquired Policies (including all incidents of ownership under Code section 2042 and the regulations promulgated thereunder) will be extinguished. Following Trust 1's contribution of the Acquired Policies, Limited Partnership, as the owner of the Acquired Policies, will designate itself as the beneficiary of the Acquired Policies. At all times, the aggregate net surrender value of the Acquired Policies will represent less than 50% of Limited Partnership's assets. The proceeds of the Acquired Policies will be paid to Limited Partnership. Further, the partnership agreement specifically prohibits a limited partner from taking part in the control of Limited Partnership's business, to sign for or to bind Limited Partnership, to participate in the day-to-day affairs and management of Limited Partnership, or to take part or vote in respect to Limited Partnership's management and operations. Limited Partnership will dissolve on the first to occur of certain specified events, one of which is the unanimous consent of all the partners. On dissolution, the distribution of partnership assets is to be made pro rata in accordance with the respective partnership interests.

It is represented that Trust 1 will transfer all of Trust 1's right, title and interest in the (two) Acquired Policies such that all incidents of ownership as defined for purposes of §2042 in the policies will vest in Limited Partnership. Further, it is represented that Limited Partnership will designate Limited Partnership as the beneficiary of the Acquired Policies. Further, the premiums for the Acquired Policies will be paid for by Limited Partnership from its own assets or loans against its own assets.

Limited Partnership intends to continue Trust 1's historical investment activities. The fair market value of Trust 1's non-insurance assets, consisting substantially of interests in multi-family residential, industrial and commercial real estate, stocks and bonds, is in excess of \$b. Trust 1 will discontinue further investment activities undertaken by Trust 1. Limited Partnership's non-insurance assets will include a 1% limited liability company membership interest in a limited liability company developing approximately m residential apartment units with an aggregate cost of between \$b and \$n. In addition, Limited Partnership anticipates making a substantial investment in a

mobile home park whose first phase consists of 60 pads with an aggregate cost of between \$p and \$b.

Law and Analysis

Issue 1 (Transfer for Value)

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, however, that if a life insurance contract or any interest therein is transferred for 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 valuable consideration" is defined for purposes of §101(a)(2) in §1.101-1(b)(4) of the Income Tax Regulations, as any absolute transfer for value of a right to receive all or part of the proceeds of a life insurance policy.

An exception to the 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, 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 rule of §101(a)(2) will not affect the application of §101(a)(1) to amounts received by the beneficiaries.

Sections 761(a) and 7701(a)(2) 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), unless it elects otherwise, a domestic eligible entity with two or more owners is considered a partnership for federal tax purposes. Sections 761(b) and 7701(a)(2) define "partner" as a member of a partnership.

Under §301.7701-3(b)(1), 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.

In this case, Grantors, who are the insureds under the Acquired Policies, are limited partners in Limited Partnership. The Acquired Policies will be transferred from Trust 1 to Limited Partnership. Limited Partnership will be named as beneficiary of the Acquired Policies and, as such, proceeds from the Acquired Policies will be paid to Limited Partnership upon the death of the survivor of Grantors.

Based solely on the facts submitted and representations made, it is concluded that Limited Partnership will be treated as a partnership for federal tax purposes and Grantor 1 and Grantor 2 as partners in Limited Partnership for federal tax purposes. The proposed transfer of Trust 1's interest in the Acquired Policies on the joint lives of Grantor 1 and Grantor 2 is a "transfer for a valuable consideration" as defined in §1.101-1(b)(4) of the regulations, whose transferee, Limited Partnership, is a partnership in which the insured is a partner. Thus, the proposed transfer will satisfy the requirements of §101(a)(2)(B), and will not affect the application of §101(a)(1) to amounts that Limited Partnership is to receive under these contracts upon the last to die of Grantor 1 and Grantor 2.

Issue 2 (Incidents of Ownership)

Section 2042(2) provides that the value of a decedent's gross estate shall include the proceeds of all life insurance policies on the decedent's life receivable by beneficiaries, other than the executor of the decedent's estate, to the extent that the decedent possessed at his death any incidents of ownership exercisable either alone or in conjunction with any other person. An incident of ownership includes a reversionary interest arising by the express terms of the policy (or other instrument) or by operation of law only if the value of such reversionary interest exceeds 5% of the value of the policy immediately before the death of the decedent.

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 a policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his 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.

Section 20.2042-1(c)(4) provides that a decedent is considered to have an incident of ownership in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, either alone or in conjunction with another person or persons, has the power, as trustee or otherwise, to change the beneficial ownership of the policy or its proceeds or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

Section 20.2042-1(c)(6) provides that, in the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling shareholder, the corporation's incidents of ownership will not be attributed to the decedent through stock ownership to the extent the proceeds of the policy are payable to the corporation. However, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent's stock holdings in the corporation for purposes of §2031, any incidents of ownership held by the corporation as to that

part of the proceeds will be attributed to the decedent through the stock ownership where the decedent is the sole or controlling shareholder.

In Estate of Knipp v. Commissioner, 25 T.C. 153 (1955), acq. in result, 1959-1 C.B. 4, aff'd on another issue, 244 F.2d 436 (4th Cir. 1957), cert. denied, 355 U.S. 827 (1957), a partnership in which the decedent was a 50% general partner, owned 10 insurance policies on the decedent partner's life at his death. The partnership paid the premiums on all of the policies, and the insurance proceeds were payable to the partnership. The court found that the partnership purchased the policies in the ordinary course of business and held that the decedent, in his individual capacity, had no incidents of ownership in the policies and, therefore, the policies were not includible in the decedent's gross estate under the predecessor to §2042(2).

Rev. Rul. 83-147, 1983-2 C.B. 158, considers whether incidents of ownership in an insurance policy owned by a general partnership would be attributed to the insured general partner. In the revenue ruling, a general partnership obtained a whole life insurance policy on the life of one of its partners. The partnership made the premium payments in partial satisfaction of the insured partner's distributive share of partnership income and the insured partner's child was designated as the beneficiary of the policy. When the partner died, the face amount of the policy was paid to the child. The revenue ruling distinguished Estate of Knipp, supra, on the basis that, in Knipp, the insurance proceeds were paid to the partnership and inclusion of the proceeds were paid to the partnership and inclusion of the proceeds in the gross estate under §2042 would have resulted in "unwarranted double taxation" of a substantial portion of the proceeds because proceeds included were included in the value of decedent's partnership interest. In contrast, in the revenue ruling, the proceeds are payable to a third party for a purpose unrelated to the general partnership business, and thus, would not be included in the value of the partnership interest included in the gross estate. Accordingly, the ruling concludes that under these circumstances, the incidents of ownership are treated as held by the insured general partner in conjunction with the other partners. The ruling further states that the Service did not agree with any implication that incidents of ownership should not be attributed to an insured partner when the proceeds are payable other than to or for the benefit of the partnership.

In the present case, the terms of the partnership agreement preclude the limited partners from exercising any control over the management and investment decisions of Limited Partnership or from taking part in the control of the Limited Partnership's business, to sign for or bind Limited Partnership, to participate in the day-to-day affairs and management of Limited Partnership, or to take part in or vote in respect to Limited Partnership's management and operations. Accordingly, based solely on the facts submitted and representations made, it is concluded that Grantor 1 and Grantor 2 will not possess any incidents of ownership under §2042 with respect to the policies contributed by Trust 1 by reason of the Grantors' q% limited partnership interests in Limited Partnership.

Caveats

1. This ruling is based on the facts presented and the applicable law in effect on the date of this letter. If there is a change in material fact or law before the transactions considered in this ruling take effect, the ruling will have no force or effect. Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the proposed transaction under any provision of the Code or regulations.

2. Specifically, no opinion is expressed concerning whether the contracts on the lives of Grantors that are proposed to be transferred to Limited Partnership qualify as "life insurance contracts," as defined in § 7702(a).

3. Specifically, no opinion is expressed concerning Grantors' status as partners in Limited Partnership for federal tax purposes if there is a reduction in Grantors' percentage interest in Limited Partnership, or concerning Grantors' federal tax classification as a partnership if Limited Partnership disposes of all of its assets other than life insurance policies.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any tax return to which it is relevant.

Pursuant to powers of attorney on file, a copies of this letter are being sent to the taxpayers.

Sincerely,
Acting Associate Chief Counsel
(Financial Institutions and Products)
By: Mark S. Smith
Chief, Branch 4