



# Estate Planning Report®

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## IRS Settles Income Tax Treatment of Life Settlements

Years ago, in response to the AIDS epidemic, the concept of a viatical settlement for a life insurance policy was born. Persons who were suffering from catastrophic and likely terminal illnesses needed a means to tap into their life insurance policies to help meet their lifetime medical expenses. A viatical settlement is the sale of the insurance policy before maturity to an unrelated third party, with the buyer assuming responsibility for premium payments and collecting proceeds at the insured's death.

More recently, a similar market, dubbed life settlements, has developed for insurance policies that no longer meet the needs of their owners. In this case, the owner who is selling the policy has no health problems, so the price paid for the policy is based upon actuarial life expectancies. For example, a business owner who has retired and sold his business might find that an insurance policy acquired to provide estate liquidity is no longer necessary and is expensive to maintain. He might accept the cash surrender value of the policy, or he might be able to sell it to a third party and reap considerably more. Press accounts have suggested, for example, that a \$1 million policy with a cash surrender value of \$50,000 might be sold for \$200,000, depending upon the terms of the policy and the age of the insured.

Life insurance companies have not been happy with the development of this market. They may take some comfort from two IRS rulings released May 1 that some observers feel will put a damper on life settlements.

### New rulings

IRS establishes the traditional baseline with Situation 1 of *Revenue Ruling 2009-13*, which covers tax issues for the owner-seller of the insurance policy. Taxpayer has paid \$64,000 in premiums over an eight-year period for a policy with a cash surrender value of \$78,000. The Service stipulates that the surrender value reflects a "cost-of-insurance" charge of \$10,000.

If the owner surrenders the policy to collect the \$78,000, IRC §72(e) governs the tax consequences. The owner's basis in the policy is the premium payment. The excess of the surrender value over the

premiums paid, here \$14,000, is taxed as ordinary income. Although the insurance policy is a capital asset, there is no sale or exchange, so ordinary income tax treatment is required.

Same facts, but the owner sells the policy for \$80,000. In Situation 2 the Service notes that IRC §72 does not apply to this situation, so general tax rules must be invoked. The basis in the policy must be reduced by the value of the insurance coverage received to that point, here \$10,000. The Service holds that the inside buildup, the difference between the premiums and the cash surrender value (\$14,000), is taxed at ordinary income rates, while the rest of the gain gets the benefit of capital gain tax rates. However, because of the basis adjustment, that gain will be \$12,000. Because of the stipulated values, the sale in this example won't make sense on an after-tax basis.

Situation 3 involves the sale of a term policy, rather than a whole-life policy, so there is no cash surrender value. Taxpayer paid \$45,000 in premiums and sold the policy for \$20,000. Once again, Taxpayer's basis in the policy is the amount of premiums paid, reduced by the value of the pure life insurance protection received to the date of the sale. The Service holds that for term policies the presumption must be that the value of the protection is equal to the entire value of the premiums paid. In the example, the Service stipulated an adjusted basis of \$250, based upon the unexpired portion of the last premium payment, so the Taxpayer's gain was \$19,750. The entire gain is taxed at low capital gain rates.

### Investor/buyer tax rules

*Revenue Ruling 2009-14* also provides three examples for investors in life insurance policies to consider. In Situation 1 of this Ruling, Buyer acquired a term policy from an unrelated policy for \$20,000 and paid an additional \$9,000 in premiums. The insured died, and the investor collected \$100,000 in proceeds. IRS holds that although life insurance proceeds are not normally includible in gross income, they are included when the policy is acquired in a transfer for value, as here. The investor's basis will be the \$20,000 acquisition cost and the \$9,000 of additional premium payments.

What's more, the Service holds that the \$71,000 is taxed as ordinary income, because the payment of the death benefit was not a sale or exchange.

Same facts, but now the investor sells the policy to an unrelated investor before the insured dies, so that the successor investor will take over the premium payments. The sale is for \$30,000. The Service finds \$1,000 of taxable income in the transaction, taxed at capital gain rates because there has been an exchange. There is no basis adjustment for the value of the insurance protection, because the protection was not on the life of the investor, but on the life of the insured. There was no ordinary income element because it was stipulated to be a term policy, without a cash value. Presumably, had a whole-life policy been the subject of the transaction, any inside

buildup that occurred while the first investor paid premiums would be taxed at ordinary income rates, under the logic of *Revenue Ruling 2009-13*.

Situation 3 parallels Situation 1, except that the buyer is a foreign corporation. IRS holds the excess of the death benefits paid over the acquisition and premium costs to be U.S. source income, subject to U.S. income taxation.

## Effective dates

*Revenue Ruling 2009-13* will not be applied adversely to sales occurring before August 26, 2009. *Revenue Ruling 2009-14*, on the other hand, will be applied retroactively to all transactions.

## Recent Developments

### Reliance Upon Professional Advice Relieves an Estate of Tax Penalties.

*Estate of Kwang Lee v. Comm'r*, T.C. Memo 2009-84

In the spring of 2001, upon learning that they both had cancer, Mr. and Mrs. Lee approached their neighbor, municipal judge Anthony Frese, about having their wills drafted. As this was not Judge Frese's area of expertise, he asked another lawyer to recommend an experienced estate planning attorney and directed the Lees to that person. The wills were drafted; Judge Frese was named executor of both; Mr. Lee died in August 2001; and Mrs. Lee died in September 2001.

The wills included a six-month survivorship clause. As executor, Judge Frese hired the wills' draftsman to assist in preparing the estate tax returns. The attorney obtained an automatic six-month extension for filing Mr. Lee's estate return. When it still wasn't ready, a second extension was requested, and Judge Frese was kept apprised of the situation.

As eventually filed, Mr. Lee's estate tax return claimed a marital deduction based upon the assumption that Mrs. Lee died first. This was inappropriate. Moreover, there is no automatic second extension for filing an estate tax return, so the filing for Mr. Lee was untimely. To the estate tax deficiency of \$1,020,129, the IRS added a \$255,032 penalty for untimely filing [IRC §6651(a)(1)] and a \$204,026 accuracy-related penalty [IRC §6662(a)].

The Tax Court voids both penalties. Throughout the period of estate settlement, Judge Frese relied reasonably and in good faith upon the advice of an estate planning professional. The estate is not further penalized for the fact that the professional made significant advisory errors.

### Trustee of a Revocable Trust May Advise Contingent Beneficiaries When Changes Are Made to the Trust Terms.

*JP Morgan Chase v. Longmeyer*, Supreme Court of Kentucky

The chronology:

- 1984, wealthy widow Ollie Skonberg hires attorney James Coorssen to prepare her will and revocable living trust. A bank is named trustee.
- 1987, Skonberg employs Coorssen to modify the trust terms, naming several charitable remaindermen. She pays him \$100 for this service.
- As Skonberg's health deteriorates, she employs Vicki Smothers as her primary caregiver. Smothers is granted a bequest of \$20,000 in Skonberg's will.
- August 1997, nearly bedridden, at Smothers' recommendation Skonberg hires a new attorney, John Longmeyer, to draft a new estate plan. Smothers' bequest is boosted to \$500,000, and the charities are removed as beneficiaries. Longmeyer takes over as trustee, discharging the bank. He charges at least \$13,000 for the new plan.
- Skonberg dies six weeks later.

Apparently, there were no close relatives available to help advise Skonberg or claim a share of her estate. After Skonberg's death the discharged bank trustee contacted a trusts and estates attorney about the questionable circumstances that attended the overhaul of

Skonberg's estate plan. He advised the bank that it should notify the earlier beneficiaries of the trust of the nature of the revisions and the dubious circumstances involved. The bank did just that.

The charities filed a will contest action, which was settled by the estate for \$1.875 million on the eve of trial.

Longmeyer in turn sued the bank for breaching its fiduciary duty. He felt that information on the identities of the original charitable beneficiaries of the trust was confidential, that they would not have sued had the bank kept quiet, and that it had a duty either to Skonberg or to her estate to keep the information secret. The bank received a favorable summary judgment, with the court holding the exact opposite, that there was a fiduciary duty to the contingent beneficiaries that required the notification. The Court of Appeals reversed, ordering a new trial, but the Supreme Court of Kentucky now reinstates the trial court's judgment.

Under Kentucky trust law, the trustee's duties extend to conditional and contingent beneficiaries. This includes the right to be kept informed about their interest or expectancy in the trust.

## Discount for a Fractional Interest in an Art Collection Is Limited to 5%.

Robert Grove Stone, et al. v. U.S., No. 07-17068 (Ninth Circuit Court of Appeals)

An estate included an undivided 50% interest in a 19-painting art collection. By comparing this interest to fractional interests in real estate and limited partnership shares, the estate claimed a 44% discount to the includible value of the art. However, because the appraiser did not examine the art market specifically, and used an unreasonably low appreciation rate and an unreasonably high present-value discount rate,

the District Court rejected the testimony. A minimal 5% discount, which the IRS had conceded, was granted. On appeal, *held*, the burden of proof for establishing an appropriate discount rate falls upon the taxpayer. The District Court did not clearly err in accepting the IRS' value theory over the estate's in these circumstances.

## Assets Transferred to Family Limited Partnerships Are Included in an Estate.

Estate of Jorgensen, et al. v. Comm'r, T.C. Memo 2009-66

Two family limited partnerships were created for the management of a securities portfolio. Among the nontax reasons alleged by the taxpayer for using this approach: management succession, financial education of family members and promotion of family unity, perpetuation of the parents' investment philosophy and motivating family participation in the FLPs, pooling of assets, alleviation of spendthrift beneficiary concerns, and providing for children and grandchildren equally. *Held*, an FLP was not required to achieve any of these goals when the FLP held no business interests, only a portfolio of investment securities. For example, the "investment philosophy" was simply buy and hold, for which an FLP is superfluous. Grandchildren may be treated equally with direct transfers of securities, and so on. Partnership formalities were not adhered to, and there was some payment of personal expenses with partnership funds. Therefore, the entire value of assets transferred to the FLPs by Jorgensen must be included in her estate under IRC 2036(a)(1).

Because the beneficiaries assumed that certain assets were not included in the estate, they did not take a corresponding basis step-up and so paid capital gains taxes upon the sale of the assets after Jorgensen's death. They may file amended returns for the open years. The Tax Court holds that under the doctrine of equitable recoupment, the estate may claim an offset for the capital gains taxes paid in error in the closed year.

## Washington Talk

The President's detailed 2010 Revenue proposal, issued in May, included three new revenue raisers in the estate tax area.

The first item is to require consistency in estate, gift and income tax reporting. There will be new reporting requirements, which should make enforcement more consistent. However, this provision raises only \$1.87 billion over ten years, according to the projections.

More significant, the third item would impose a ten-year minimum term for a Grantor Retained Annuity Trust. Treasury wants to "crack down" on two-year zeroed-out GRATs, which are ways to play the transfer tax lottery without risk. A ten-year term definitely would put

a survival risk into the equation. This proposal raises \$3.25 billion over ten years.

But the real money is in the second item on the list, at more than \$19 billion over ten years. We already have in the tax code IRC §§2701 to 2704 to prevent the claiming of valuation discounts for certain intrafamily transfers. However, the Treasury reports that clever taxpayers (or their advisors) have figured out ways around these restrictions, so a new group would be added. The proposal would create a whole new category of restrictions to be ignored in valuing an interest in a family-controlled entity. Appropriately, they will be called "disregarded restrictions."

Family Limited Partnerships are the target of this change.

The President's budget also freezes the 45% tax rate and \$3.5 million exemption of 2009.

**Bring back the credit for state death taxes**, says the New York City Bar Association's Committee on Estate and Gift Taxation in an April 29 letter to the Treasury. The credit was phased out under the Economic Growth and Tax Relief Reconciliation Act of 2001 to offset the revenue loss from increasing the amounts exempt from federal estate tax. However, those states that only used a "pick-up" estate tax linked to the federal credit have lost their death tax revenues as a result. Currently, 26 states are in that position, and the rest have "decoupled" from the federal law to preserve either estate or inheritance tax at the state level.

The Bar Association identifies four problems with this situation:

- *Forum shopping.* The estate of a New York widow worth \$5 million will owe \$391,600 in New York State estate tax if she dies in 2009. Should she move to Florida, the entire state death tax would be avoided.
- *Planning complexity.* For couples in states such as New York, with a wide gulf between federal and state exempt amounts, the best tax-planning approach is not always obvious. Should they maximize the marital deduction for the federal tax or the state tax? The largest estates may tend to profit by incurring some state death tax when the first spouse dies for a larger tax shelter when the second spouse dies, but that "luxury" (the word used by the Bar Association) may not be available to less affluent couples.
- *Added compliance costs.* Under the old system state death tax collections were relatively easy, because each estate had to prove

payment of the state death tax to claim the credit. Now the states must create a more elaborate enforcement infrastructure.

- *Costs of legislative change.* States have had to write new laws in order to decouple from the federal rules.

Given that a majority of states have chosen not to decouple, and the fact that restoration of the federal credit for state death taxes would increase the federal deficit, the odds on its restoration appear to be long.

**IRS updates the "dirty dozen."** The most notorious scam on the 2009 list of tax-avoidance scams that are too good to be true is "phishing," in which con men send e-mails that appear to be from the IRS. The object is identity theft. Taxpayers should forward suspicious emails to [phishing@irs.gov](mailto:phishing@irs.gov); to date thousands of IRS phishing sites have been identified.

The Service also warns about:

- abuse of charitable organizations and deductions;
- abusive retirement plans;
- disguised corporate ownership; and
- misuse of trusts.

In particular, the Service has in recent years seen an increase in the improper use of private annuity trusts to divert income and create deductions for personal expenses. The Service advises getting an opinion from a trust professional before entering into a trust arrangement.

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