Internal Revenue Service

Department of the Treasury

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Contact Person:

Telephone Number:

In Reference to:
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Date: July 13, 1999

Legend

Sister 1 -
Sister 2 -

State -

Father -

Mother -

Issuer -

Month 1 -

Date 1 -

Month 2 -

Date 2 -

Date 3 -

Amount 1 -

Policy 1 -

Amount 2 -

Amount 3 -

Amount 4 -

Amount 5 -

Policy 2 -

Amount 6 -

Amount 7 -

Date 4 -

Date 5 -

Amount 8 -

Amount 9 -

Amount 10 -

Amount 11 -

Amount 12 -

Dear

This is in response to your letter of March 10, 1999 requesting a ruling that the purchase by your clients of a life insurance policy on the lives of their parents did not constitute a "transfer for value" under § 101 of the Internal Revenue Code. Your April 14th and 26th , 1999 letters provided supplemental information respecting that request.

Facts

Sisters 1 and 2 are both residents of State. Their parents are Father and Mother. As part of a plan to provide estate liquidity upon the deaths of Father and Mother, Sister 1 purchased Policy 1, a survivorship ("second to die") whole life insurance policy on their lives with a death benefit of Amount 1. The policy was issued by Issuer on Date 1, listing Sister 1 as policy owner and beneficiary, and Mother and Father as insureds. Before Date 1, Sister 1 paid the first annual policy premium of Amount 2, and the policy went into effect.

Early in Month 2, Issuer mailed Sister 1 the second annual premium notice. The notice stated that Sister 1 was required to pay Amount 2 by Date 2 to keep Policy 1 in force. Sister 1 did not pay any portion of Amount 2, having determined that Policy 1 was too expensive and that she did not need the full amount of coverage it provided.

Policy 1 provided that if premiums had been paid to date, any premium, other than the first, not paid when due, could be paid within a grace period of 31 days after its due date. It provided further that:

(a) the policy would be continued "in full force" during that 31 day period;

(b) if the premium had not been paid within the grace period, the insurance would cease to be in force at the end of 31 days after the due date of the unpaid premium; and,

(c) if the policy had a surrender value, Issuer would apply that value as a net single premium to provide insurance on an adjusted basis as of the due date of the unpaid premium.

Policy 1 also provided that it could be reinstated within 3 years after the due date of the first unpaid premium provided that:

(1) both insureds were alive or one insured was alive and the lapse occurred after the death of the other insured;

(2) the surrender value had not been paid or otherwise exhausted;

(3) an application for reinstatement was filed;

(4) satisfactory evidence of insurability was received;

(5) overdue premiums with interest at 6% were paid; and,

(6) any indebtedness (including interest) outstanding when the policy lapsed was paid or reinstated.

As of Date 3, Sister 1 had paid no portion of the renewal premium on Policy 1. Consequently, under its terms, that policy lapsed. Pursuant to its terms, the cash value of Policy 1 at the end of its first policy year was Amount 3. Again, pursuant to its terms, the amount of that cash value was to be applied to provide paid up insurance in the amount of Amount 4. There is no information in the file regarding whether any such paid up policy was, or was not, issued.

During the months following Date 3, Sister 1 determined that the optimal amount of coverage on the lives of Father and Mother was Amount 5, and that she could afford annual premiums so long as they did not exceed Amount 6. Sister 1 then contacted an

Issuer agent seeking policy quotes in the range of Amount 6. Sister 1 was provided with several options, one of which was for a policy with a death benefit of Amount 5 and an annual premium of approximately Amount 7. Sister 1 then contacted Sister 2 to determine whether Sister 2 would be willing to share the cost of such a policy. Sister 2 agreed to do so.

On or about Date 4 Sister 1 advised the Issuer agent that she and Sister 2 wished to purchase Policy 2, a survivorship ("second to die") whole life insurance policy on the lives of Father and Mother with a death benefit of Amount 5. The Issuer agent provided Sister 1 with a document entitled Request With Respect To Policy Or Application. On that document Sister 1 stated:

> Please reinstate the above policy as a[n] [Amount 5] policy - [Amount 8] base amount and [Amount 8] Additional Protection Rider. The AIP Rider premium will be [Amount 9] and the total annual premium will be [Amount 10].
>
> The current owner and beneficiary for this policy is [Sister 1]. Please change the owner at this time to [Sister 1] and [Sister 2], jointly. Please change the beneficiary at this time to [Sister 1] and [Sister 2], equally. . . .

Pursuant to that Request, Issuer issued Policy 2. The stated Date of Issue and Policy Number of Policy 2 were the same as the stated Date of Issue and Policy Number of Policy 1.

The terms of Policy 1 provided that in order to reinstate it in the event of the nonpayment of premiums, overdue premiums with interest at 6% had to be paid. However, no overdue premiums were paid at the time Policy 2 was issued. Instead, Sisters 1 and 2 received an invoice reflecting the annual premium of Amount 10 plus an amount (Amount 11) characterized as interest. Sisters 1 and 2 state the latter amount did not represent interest on the amount due on Date 2. On Date 5 Sisters 1 and 2 each made a payment of Amount 12 to Issuer.

Sisters 1 and 2 represent that: Sister 2 had no legal obligation to Sister 1 to pay any premium on Policy 2; Sister 1 had no legal right to compel Sister 2 to pay any such premium; and that Sister 2 made no payment of any consideration to Sister 1 in connection with the transfer of, or for any right Sister 1 had in Policy 1 or Policy 2.

Ruling Requested

Sisters 1 and 2 request a ruling that their purchase of Policy 2 does not constitute a transfer for a valuable consideration under § 101 of the Code.

Law and Analysis

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, generally, that if a life insurance contract or any interest therein is transferred for a valuable consideration, by assignment or otherwise, 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. Section 101(a)(2)(A) provides an exception in the case of a transfer of an interest in a life insurance contract if that interest has a basis for determining gain or loss in the hands of the transferee determined in whole or in part by reference to the basis of such interest in the hands of the transferor.

Section 1.101-1(b)(4) of the regulations defines the term "transfer for a valuable consideration" as "any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy." Section 1.101-1(b)(4) provides further that the creation for value of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for a valuable consideration of the policy or of an interest in the policy.

Section 1015 provides generally that in the case of property acquired by gift, the basis of the property for the purposes of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. The same rule applies for purposes of determining basis for loss unless the basis, with certain adjustments not relevant here, is greater than the fair market value of the property at the time of the gift. In such a case, the basis for determining loss is the fair market value at the time of the gift.[1]

In James F. Waters, Inc. v. Commissioner, 160 F.2d 596 (9th Cir. 1947) the taxpayer acquired a life insurance policy in a carryover basis transaction by operation of law in a merger. However, the transferor had acquired the policy for valuable consideration. After the merger, the taxpayer allowed the policy to lapse. Pursuant to its terms, the policy was converted into a paid-up policy. Upon the death of the insured, the taxpayer received the proceeds of that paid-up policy.

In Waters, the taxpayer argued that the predecessor of the carryover basis rule presently contained in § 101(a)(2)(A) required that it be permitted to exclude the policy proceeds from income. It argued further that even if the predecessor of that rule did not

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[1]Section 1.1015-4(a) of the regulations provides that in the case of a transfer that is in part a sale, and in part a gift, the transferee's basis for determining gain is the greater of the amount paid by the transferee or the transferee's adjusted basis for the property at the time of transfer, plus the amount of any increase in basis authorized by § 1015(d) for gift tax paid. The basis for determining loss in such a case is the fair market value at the time of the transfer.

dictate such a result, the paid up policy was a different policy from the policy it acquired in the merger, and that it did not acquire the paid up policy for valuable consideration. For reasons that are not relevant to this ruling, the Court of Appeals held that the carryover basis rule did not apply to exempt the proceeds from tax. It then indicated,

> As an alternative the taxpayer claims that [the predecessor of § 101(a)(2)] is inapplicable because of the lapse of the policies . . . for non-payment of premiums. The argument proceeds on the assumption that the policies were not thereafter the same contracts as those transferred. The assumption is groundless. No new contracts came into existence. The changes in periods and amounts of insurance were effected by the terms of the insurance contracts as written in the first instance.

160 F.2d at 597.

In the present case, even if Policy 2 is treated as a continuation of Policy 1, there has been no transfer for a valuable consideration. Sisters 1 and 2 have represented that Sister 2 made no payment of any consideration to Sister 1 in connection with the transfer of, or for any right Sister 1 had in, Policy 1 or Policy 2; Sister 2 owed no legal obligation to Sister 1 to pay any premium on Policy 1 or Policy 2; and, Sister 1 had no legal right to compel Sister 2 to pay any such premium. Thus a transfer, if any, by Sister 1 to Sister 2 of an interest in Policy 1 was solely by gift, and § 101(a)(2) does not apply.

Sisters 1 and 2 argue that Policy 2 is a new policy, and not a continuation of Policy 1. Under their analysis, each of them simply agreed to purchase a one half interest in Policy 2 at the time of its initial issuance, and no portion of that policy was transferred for valuable consideration or otherwise from Sister 1 to Sister 2. Therefore, again, there was no transfer for valuable consideration within the meaning of § 101(a)(2).

Conclusion

We conclude, under the facts presented, that the exclusion provided in § 101(a)(1) for the proceeds of Policy 2 payable upon the death of the insured will not be limited by § 101(a)(2).

The ruling contained in this letter is based on information and representations submitted by Sisters 1 and 2. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination.

We express no opinion as to the tax treatment of the subject transaction under any other section of the Code or regulations that is not covered by this ruling. Specifically, we express no opinion as to whether Policy 2 qualifies as a life insurance contract under § 7702(a) or is a modified endowment contract within the meaning of § 7702A(a).

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

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

Sincerely,
Assistant Chief Counsel
(Financial Institutions and Products)

By: /s/
Mark S. Smith
Chief, Branch 4