INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 10, 2004

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Date1 =
Date 2 =
Date 3 =
Date 4 =
Decedent =
Spouse =
LLC =
State =
Company =
Year 1 =
Year 2 =
Policy =
$a =
$b =
$c =
$d =
$x =
w% =

y% =
z% =

ISSUES:

Issue 1. Is any portion of the proceeds payable on Policy, an insurance policy on Decedent's life, includible in Decedent's gross estate under sections 2035(a) and 2042?

Issue 2. If any portion of the Policy proceeds is includible in Decedent's gross estate, then to what extent, if any, is Decedent's estate entitled to an estate tax marital deduction under section 2056(a) with respect to the proceeds?

CONCLUSIONS:

Issue1(a). The entire amount of the Policy proceeds are includible in Decedent's gross estate under section 2035(a).

Issue 2. Decedent's estate is not entitled to the estate tax marital deduction under section 2056(a) where the proceeds are payable to the limited liability company.

FACTS:

On Date1, Decedent and Spouse formed a limited liability company, LLC. The LLC was established under State law for the purpose of conducting the business affairs of its members. Article II of the Operating Agreement provides that the purpose of the LLC is to make a profit, increase wealth, and provide a means for the family to become knowledgeable of, manage, and preserve family assets. The Operating Agreement provides that the objective of the LLC is to accomplish the following:

(A) maintain control of family assets
(B) consolidate fractional interests in family assets
(C) increase family wealth
(D) establish a method by which annual gifts can be made without fractionalizing family assets
(E) continue the ownership of family assets and restrict the right of non-family to acquire interests in family assets
(F) provide protection to family assets from claims of future creditors against family members
(G) prevent the transfer of a family member's interest in the LLC as a result of a failed marriage
(H) provide flexibility in business planning not available through trusts, corporations or other business entities
(I) facilitate the administration and reduce the cost associated with the disability or probate of the estate of family members

(J) promote the family's knowledge of and communication about family assets

Article IV, section 4.8(a) provides that all decisions and determinations as to matters affecting the LLC and its business, properties and affairs, other than "major decisions' (as hereinafter defined) shall be made by the manager selected by vote or written consent of members owning more than 50% in amount of total Participation units. Major decisions mean any decision, determination or undertaking with respect to the LLC real property, dissolution, liquidation or termination of the LLC.

Under Article IV, section 4.8(b), the manager of the LLC will act as chief executive officer. The initial manager shall be Spouse until the earlier of her (i) death; (ii) permanent disability; (iii) withdrawal, or (iv) removal as manager, for cause. In the absence of the manager, members representing no less than 66 and 2/3% in amount of Participation Interests shall have the right to designate a non-Member to act for and on behalf of the LLC, as manager, for any specified purpose. Notwithstanding anything to the contrary contained herein, at no time shall any given member have any rights or control over any life insurance policy on the life of that member, the rights and control of which shall at all times be in the possession of the manager, or a non-control member (provided, however, that at no time shall Decedent have control, possession, ownership or possess any beneficial interests in any life insurance on his life).

Article VI, section 6.1 provides that distributions of net cash flow available for distribution after provision for all reserves shall be allocated pro rata in ratio to each member's interest in the LLC. Section 6.2 and 6.3 of Article VI provide that except as set forth in section 6.4, net income and losses shall be allocated to the members pro rata in proportion to their interest in the LLC.

Article VII, section 7.1 provides that the LLC shall terminate upon the earlier of the expiration of the term of the LLC or the occurrence of the execution at any time by all of the members of a written agreement to terminate the LLC or the entry of a decree of judicial dissolution under State law. Section 7.2 of Article VII provides that upon liquidation, the proceeds from the liquidation of the LLC assets shall be distributed first to creditors; second to members in repayment of outstanding loans and, third to members to the extent of the then balance of their respective capital accounts.

Article XII provides that a separate capital account shall be established and maintained for each member, including additional members, who shall receive any interest in the LLC. The term "capital account" shall mean the amount of the capital contributed to the LLC by a member upon formation of the LLC and as further adjusted under the terms of the LLC agreement. Contributions of capital shall mean the cash or other property contributed or to be contributed by the Members pursuant to Article V.

Decedent, rather than the Spouse who was the manager of the LLC, signed the LLC's Certificate of Formation and Amended Certificate.

Decedent and Spouse contributed assets to the LLC in Year 1 and Year 2 as follows. In Year 1, Decedent contributed a life insurance policy (Policy) on his life with a cash surrender value of $a; and Decedent and Spouse each contributed $b in cash. In Year 2, Decedent contributed a total of $c in cash and bonds and Spouse contributed a total of $d in cash and bonds. Decedent contributed y% of the total contributions to LLC, which is greater than the percentage contributed by Spouse. However, all assets that were transferred to the LLC were credited one-half to Decedent's capital account and one-half to Spouse's capital account. The cash surrender value of Policy was initially credited entirely to Decedent's capital account and, subsequently, one-half the value of Decedent's capital account attributable to Policy was credited to Spouse's capital account.

On Date 2, in Year 1, Decedent sent a letter to Company stating, "Enclosed please find the All Purpose Policy Service Application to transfer ownership of my insurance policy to LLC." At that time Decedent changed the beneficiary of Policy from Spouse to the LLC. The face value of Policy was $x. Decedent continued to pay the insurance premiums after the LLC was formed, even though by Year 2 the LLC had sufficient assets to make the payment.

On Date 3, Decedent transferred his entire interest in the LLC to his three children in substantially equal shares. On the same date, Spouse transferred a z% interest in the LLC to her three children in equal shares. The transfers were made within several months after the formation of the LLC. After the transfers, Spouse retained a w% interest in the LLC. The transfers to the children of Decedent and Spouse were reflected in the capital accounts of the five family members and on the partnership returns and the K-1. Forms 709 United States Gift (and Generation-Skipping Transfer) Tax Returns were filed, pursuant to an extension, with respect to the transfers made by Decedent and Spouse.

Decedent died on Date 4 in Year 2, approximately 16 months after Date 1, 11 months after Date 2 and within 60 days of Date 3. At the time of his death, Decedent held no interest in the LLC. Decedent's Form 706 United States Estate (and Generation-Skipping Transfer) Tax Return did not include the value of all or any portion of the Policy proceeds in Decedent's gross estate.

LAW AND ANALYSIS

Issue 1.

A. Characterization of the Transfer of Policy to LLC

In the present case, the facts support characterizing the Decedent's contribution of Policy to LLC, for transfer tax purposes, as a transfer by decedent of one-half of Policy to his Spouse.

Section 25.2511-1(a) of the Gift Tax Regulations provides that the gift tax applies to a transfer by way of gift whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Under section 25.2511-1(h) a transfer by a stockholder to a corporation is treated as a transfer to the other stockholders of the corporation. The indirect gift analysis illustrated in section 25.2511-1(h)(1) has been applied repeatedly by the courts. For example, in Shepherd v. Commissioner, 115 T.C. 376 (2000), aff'd 283 F. 3d 1258 (2002), a donor transferred land and bank stock to a general partnership in which the donor held a 50% partnership interest and the donor's two sons each held a 25% partnership interest. The transfers were allocated to each partner's capital account in proportion to their respective partnership interests. The court rejected petitioner's argument that the transfers, to the extent inuring to the benefit of the sons, should be characterized for gift tax purposes as enhancements of the then sons' existing partnership interests, and valued accordingly. Rather, the court reasoned the gift tax is imposed on the value of the property passing from the donor, and not on the value received by the donee, citing Robinette v. Helvering, 318 U.S. 184, 186, (1943). Under the facts presented, the property that the donor possessed and transferred was his interest in the land and stock. Therefore, in accordance with section 25.2511-1(h)(1), the transfer to the partnership represented indirect gifts to each of the donor's sons of undivided 25% interests in the land and stock.

In this case, Decedent contributed Policy to LLC. However, unlike the situation in Shepherd, 100% of the value of Policy was initially allocated to Decedent's capital account and, thereafter, 50% of the value of Policy was reallocated to Spouse's capital account. The transitory allocation of 50% of the value of Policy to Decedent's capital account was merely a step in an integrated transaction intended to pass 50% of the Policy to Spouse. Decedent's capital account acted as a conduit for the transfer. Accordingly, as was the case in Shepherd, the transaction is properly treated for transfer tax purposes, as a transfer of 50% of Policy directly to Spouse.

B. Application of Section 2035

Section 2001 imposes a tax on the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2035(a) provides that if (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

Section 2035(d) provides that section 2035(a) shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

Section 2042(2) provides that the value of the gross estate includes the value of all property to the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any incidents of ownership, exercisable either alone or in conjunction with any other person.

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 the policy in the technical legal sense. Generally, the term has reference to the right of the insured or the insured's 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.

As discussed above, the Decedent's contribution of Policy to LLC is properly characterized for transfer tax purposes as a transfer of 50% of Policy directly to Spouse. The transfer of one-half of Policy to Spouse was made within three years of his death. Accordingly, section 2035(a) would apply to include the gift of one-half of Policy to Spouse in Decedent's gross estate. The section 2035(d) exception does not apply because the Decedent received no consideration in exchange for one-half of Policy.

Regarding the other one-half of the Policy, the value of which was credited to Decedent's capital account, Decedent transferred the Policy within three years of his death and the value of the Policy would have been included in Decedent's gross estate under section 2042 if the Policy had been retained by Decedent on his date of death. Accordingly, the proceeds payable from the Policy are includible in Decedent's gross estate under section 2035(a), unless the exception under section 2035(d) applies.

Under section 2035(d), the proceeds are excludible from Decedent's gross estate if Policy was transferred to the LLC in a bona fide sale for an adequate and full consideration in money or money's worth. The exception under section 2035(d) is given the same meaning in sections 2036, 2038, 2037, and 2042. See Merrill v. Fahs, 324 U.S. 308 (1945). The exemption from tax under section 2035(d) is limited to those transfers of property where the transferor or donor has received benefit in full consideration in a genuine arm's length transaction; and the exemption is not allowed in a case where there is only contractual consideration but not "adequate and full consideration in money or money's worth." Estate of Goetchius v. Commissioner, 17 T.C. 495, 503 (1951).

In Estate of Harper v. Commissioner, 83 T.C.M. (CCH) 1641 (2002), Mr. Harper transferred assets to a revocable inter vivos trust and then established a limited partnership (LP) in which his two children were 1% general partners and the trust was a

99% limited partner. The trust transferred 60% of the LP interests to Mr. Harper's children after establishing two classes of LP interests. Mr. Harper died shortly thereafter. For purposes of determining the includibility of the LP interests in Mr. Harper's gross estate under section 2036, the court addressed the issue of whether the transfer of the decedent's assets to the partnership in exchange for the 99% limited partnership interest was a bona fide sale for an adequate consideration in money or money's worth.

The requirement of "a bona fide sale," requires a good faith, arms-length transaction. In Mollenberg's Estate v. Commissioner, 173 F.2d 698, 701 (2d Cir. 1949), the court stated, "The word 'sale' means an exchange resulting from a bargain." The court in Harper determined that the formation of the LP fell short of meeting the bona fide sale requirement because there was no bargaining. Mr. Harper independently of any other party determined how the LP was to be structured and operated. He essentially stood on both sides of the transaction and conducted the partnership's formation in the absence of any bargaining or negotiating whatsoever.

In the present case no evidence has been presented to support a conclusion that Decedent's formation of LLC was the result of an arm's length bargain with either Spouse or Decedent's three children. It is not known whether the Spouse and the children participated in determining the structure and operation of the LLC. It is known only that the Decedent signed the Certificate of Formation and Amended Certificate for the LLC. In addition Decedent, rather than Spouse, contributed the majority of the assets to the LLC. Decedent continued to pay the insurance premiums on Policy after the LLC was formed, even though by Year 2 the LLC had sufficient assets to make the payment. In the absence of any evidence of any bargaining or negotiating among the parties, we conclude that the Decedent's transfer of Policy to LLC did not constitute a "bona fide sale."

With regard to the requirement, that the transfer must be one, "for full and adequate consideration in money or money's worth," Decedent's estate argues that the Decedent's receipt of an LLC interest constitutes full and adequate consideration in money or money's worth for the transfer of Policy to LLC. In Harper, the court rejected the taxpayer's argument that the receipt of a partnership interest was "per se adequate and full consideration for the contributed assets."

Where a transaction does not appear to be motivated primarily by legitimate business concerns, no transfer for consideration within the meaning of section 2036(a) has taken place. The partnership or LLC interest received, rather than constituting consideration for the transfer, merely represents continued ownership of the transferred assets in a different form. Estate of Reichardt v. Commissioner, 114 T.C. 144, 155-56 (1992); Estate of Maxwell v. Commissioner, 98 T.C. 594, 603-06 (1992) aff'd, 3 F.3d 591 (2d Cir.1993); Estate of Thompson v. Commissioner, 84 T.C.M. (CCH) 374, 387-89 (2002); Estate of Harper v. Commissioner, 83 T.C.M. (CCH) 1641, 1652-54 (2002).

However, in cases where a decedent transferred his or her assets into a valid functioning business enterprise, courts have found the transfer to have been made for full and adequate consideration. See, e.g., Estate of Stone v. Commissioner, 86 T.C.M. (CCH) 551 (2003); Estate of Harrison v. Commissioner, 52 T.C.M. (CCH) 1306 (1987); Estate of Michelson v. Commissioner, 37 T.C.M. (CCH) 1534 (1978).

In the present case, the Decedent transferred Policy to the LLC and received, in part, a corresponding allocation to his capital account. The purpose of the transfer was not to contribute to the activities of an ongoing business enterprise, but simply to remove the Policy proceeds from Decedent's gross estate. Accordingly, we conclude that the receipt of the LLC interest (or increase in the capital account) in exchange for Policy does not constitute adequate and full consideration in money or money's worth for purposes of section 2035(d).

Based upon the facts presented, we conclude that Decedent's inter vivos transfer of Policy to the LLC was a substitute for a testamentary transfer, rather than a bona fide sale for adequate and full consideration in money or money's worth. Within 3 years of his death, Decedent transferred the Policy to the LLC and Spouse. Thus, within 3 years of his death, Decedent divested himself of the Policy and received no consideration for the transfers. Therefore, the entire amount of the proceeds payable on Policy is includible in Decedent's gross estate under section 2035.

Issue 2

Section 2056(a) provides that for purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by section 2056(b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Section 20.2056(c)-1(a)(4) of the Estate Tax Regulations provides that the proceeds of life insurance upon the life of the decedent are considered as having passed from the decedent to the person who, at the time of the decedent's death, was entitled to receive the proceeds.

In Example 3 of section 20.2056(c)-2(b), proceeds of insurance upon the life of H are considered as having passed from H to W if the terms of the contract meet the requirements of section 20.2056(b)-6 or provide that: the proceeds are payable to W in a lump sum; or provide that the proceeds are payable in installments to W for life and after her death any remaining installments are payable to her estate; or provide that interest on the proceeds is payable to W for life and upon her death the principal amount is payable to her estate; or provide that the proceeds are payable to a trustee

under an arrangement whereby the requirements of section 2056(b)(5)[1] or section 2056(b)(7)[2] are satisfied.

Decedent's estate has taken the position that Decedent's estate is entitled to an estate tax marital deduction for the proceeds, or at least the portion of the proceeds attributable to the one-half Policy gifted to Spouse and includible in Decedent's gross estate. The estate asserts that such a result would be a corollary to treating the gift to Spouse as a one-half gift in Policy, rather than a gift of an LLC interest.

However, the requirement that the property, i.e. the proceeds, pass to the surviving spouse is not satisfied in this case. The proceeds are payable to the LLC, not to Spouse. Decedent's estate has not offered any arguments to the contrary. At the time of Decedent's death, Spouse only held a w% interest in the LLC. It is represented that the proceeds were invested by the LLC and were not distributed outright to Spouse. Under the LLC Agreement, Spouse would be entitled to her distributive share of income only. Spouse is not entitled to a lump sum payment of the proceeds or installments of income for life from the proceeds. Upon her death, the remaining proceeds are not payable to Spouse's estate. Spouse does not have a power to appoint the proceeds. No interest in or portion of the proceeds passes to Spouse in a form meeting the requirements of sections 2056(a), 2056(b)(5) or 2056(b)(7). Accordingly, we conclude that Decedent's estate is not entitled to the estate tax marital deduction under section 2056 for any portion of the proceeds payable to the LLC.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

[1] Allowing a marital deduction in the case of a terminable interest passing to the spouse if the spouse receives a life income interest in trust coupled with a general power of appointment exercisable by the spouse alone and in all events.

[2] Allowing a marital deduction in the case of qualified terminable interest property passing to the spouse.