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Department of the Treasury
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Person To Contact:
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Telephone Number:

Refer Reply To:
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Date:
October 24, 2005

Re: Private Letter Ruling Request

LEGEND

Year 1 =
Husband =

a =
Wife =

b =
Date 1 =
Child 1 =

c =
d =
e =
Insurance Agent =
Year 2 =

Dear :

This letter responds to your authorized representative's letter dated February 23, 2005, that requests rulings regarding the gift and estate tax consequences of a proposed reformation and assignment of a life insurance policy.

FACTS

The facts and representations submitted are summarized as follows:

In Year 1, Husband was the owner and insured of a life insurance policy ("Individual Policy of Husband") having a net interpolated terminal reserve value of $a and Wife was the owner and insured of a life insurance policy ("Individual Policy of Wife") having a net interpolated terminal reserve value of $b.

On Date 1, Husband and Wife, the four children of Husband and Wife (“the children”), and Child 1, signing as trustee of a revocable trust created on the same date (“the Trust”), each executed an instrument entitled “Transfer by Gift.” Paragraph 1 of the instrument provides that Husband and Wife transfer and assign the Individual Policy of Husband and the Individual Policy of Wife to the trustee of the Trust. Paragraph 2 of the instrument provides that the transfer of the policies is subject to a deferred obligation from the Trust to Husband and Wife represented by a note in an amount equal to $c, which is the combined value of the policies less $d, the amount anticipated to be excluded from the total amount of gifts made by Husband and Wife during such year under § 2503(b) of the Internal Revenue Code. Paragraph 3 provides that Husband and Wife intend to exchange the policies for a single “last-to-die” policy (“Joint and Survivor Insurance Policy”) having a face amount of $e that will be the property of the Trust in lieu of the two policies described above. Paragraph 4 provides that each beneficiary of the Trust acknowledges the gift to Trust and that each intends to contribute sufficient funds to Trust to satisfy the deferred balance and to pay ongoing premiums on the policy as needed to keep it in force, subject to the rights under the Trust. The final paragraph of the instrument provides that Husband and Wife acknowledge that the transfer is a “split gift,” to be considered as made one-half by each spouse under § 2513, in favor of each of their four children in an amount equal to the amount of the annual exclusion allowable under § 2503(b).

The trust instrument of the Trust appoints Child 1 as trustee. Paragraph 1 of the trust instrument acknowledges delivery of the insurance policies, subject to the note payable to Husband and Wife in the amount of $c. Paragraph 2 of the trust instrument vests the trustee with all right, title and interest in and to the cash and policy or policies acquired by the trustee and authorizes the trustee to exercise and enjoy all the options, benefits, rights and privileges under the policies. Paragraph 2 also directs any insurance company that issues a policy to recognize the trustee as the absolute owner of the policy and further indicates that the trustee is fully entitled to all options, rights, privileges, and interests under such policies. Paragraph 13 of the trust instrument provides that notwithstanding any other provision, the Trust shall be revocable by any of the children who may, at any time, revoke his or her participation in the Trust and withdraw his or her share of its assets.

Shortly after the execution of the “Transfer by Gift” instrument, Husband and Wife met with Insurance Agent, now deceased, and directed him to exchange the two individual policies for a Joint and Survivor Insurance Policy and to title the new policy in the name of the Trust. Insurance Agent presented a number of documents for Husband and Wife to sign in relation to the new policy, whereupon, Husband and Wife assumed Insurance Agent had properly completed the transactions. In fact, the two individual policies were properly exchanged for a Joint and Survivor Insurance Policy, but the new policy continued to list Husband and Wife as owners of the policy.

Neither Husband nor Wife has filed a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for Year 1.

On January 1st of Year 2, Husband and Wife executed an instrument entitled "Declaration of Gift and Forgiveness of Note." The instrument provides that Husband and Wife forgive by gift the note in the amount of $c that was executed on Date 1 by Child 1 as trustee of the Trust. No payments had been made on the note.

Since the date of issuance of the Joint and Survivor Insurance Policy in Year 1, premium notices on the policy have been sent by the insurance company to Child 1 as trustee of the Trust. Child 1, as trustee of the Trust, paid all the premiums due on the policy.

Recently, it was discovered that the Joint and Survivor Insurance Policy lists Husband and Wife, and not the Trust, as the owners of the policy. Husband and Wife now intend to reform the Joint and Survivor Insurance Policy to clarify that the Trust is the owner of the policy by executing a valid assignment of the policy in favor of the Trust.

The following rulings have been requested:

1. The reformation and assignment of the Joint and Survivor Insurance Policy to reflect the Trust as the owner of the policy will not be considered a taxable gift under § 2512.

2. The proceeds of the Joint and Survivor Insurance Policy will not be includible in the gross estate of either Husband or Wife under § 2035 if one or both die within three years of the reformation and assignment of the Joint and Survivor Insurance Policy to reflect the Trust as the owner of the policy.

LAW AND ANALYSIS

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

Section 2503(b) as in effect in Year 1 provided that in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, for purposes of § 2503(a), be included in the total amount of gifts made during such year.

Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(c)(1) of the Gift Tax Regulations provides that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeds the value of the consideration shall be deemed a gift and shall be included in computing the amount of gifts made during the calendar year.

Section 25.2512-8 provides that transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth.

Transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift. See Harwood v. Commissioner, 82 T.C. 239, 258 (1984), aff'd without op., 786 F.2d 1174 (9th Cir. 1986). In general, if an individual makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan. See Rev. Rul. 77-299, 1977-2 C.B. 343; Maxwell v. Commissioner, 3 F.3d 591 (2nd Cir. 1993); Deal v. Commissioner, 29 T.C. 730 (1958).

Section 2513(a)(1) provides that a gift made by one spouse to any person other than his spouse shall, for purposes of this chapter, be considered as made one-half by him and one-half by his spouse, but only if at the time of the gift each spouse is a citizen or resident of the United States.

Section 2513(a)(2) provides that § 2513(a)(1) shall apply only if both spouses have signified (under the regulations provided for in § 2513(b)) their consent to the application of § 2513(a)(1) in the case of all such gifts made during the calendar year by either while married to the other.

Section 25.2513-2(b)(1)(i) provides that the consent required by § 2513(a)(2) may not be signified after the 15th day of April following the close of the calendar year of the gift unless before such 15th day, no return has been filed for the year by either spouse, in which case the consent may not be signified after a return for the year is filed by either spouse.

Section 2035(a) provides that if the decedent made a transfer 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 the value of such property would have been included in the decedent's gross estate under § 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 which would have been so included.

Section 2042 provides, in part, that the value of the gross estate shall include 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 of the incidents of ownership, exercisable either alone or in conjunction with any other person.

In general, the provisions of the insurance policy ("policy facts") govern the relationships between the insured, the insurer, the owner and the beneficiary. See Commissioner v. Noel, 380 U.S. 678 (1965); United States v. Rhode Island Hospital Trust Co., 355 F.2d 7 (1st Cir. 1966); Estate of Fuchs v. Commissioner, 47 T.C. 199 (1966), acq., 1967-1 C.B. 2. Moreover, evidence to the effect that policy facts do not conform to the intent of the parties ("intent facts") must overcome the heavy presumption in favor of policy facts.

In Rhode Island Hospital Trust Co., an insurance policy naming decedent's father and mother as beneficiaries was obtained on decedent's life by his father 34 years prior to decedent's death. Decedent's father regarded the policy as belonging to him and he kept the policy in his own safe deposit box and paid all the premiums on the policy. On the death of decedent's mother, decedent's father directed decedent to change the policy beneficiary to reflect decedent's father as the primary beneficiary and decedent made the change. In spite of these facts, the First Circuit held that decedent had the necessary incidents of ownership over the insurance policy to bring the proceeds into his gross estate under § 2042. The court noted that incidents of ownership depend on a legal power to exercise ownership of the policy. The court examined the policy at issue and determined that, without gaining possession of the policy, the decedent could have borrowed on the policy, changed the method of using the dividends, assigned the policy, and revoked the assignment. The court further noted that decedent's signature was necessary to change the beneficiary, to surrender the policy for cash value, to alter the policy and to change the dividend options. 355 F.2d at 11.

The court, however, indicated that there is an exception to the general rule that the terms of the policy determine the ownership of the policy. The court stated as follows:

> To the principle of heavy predominance of the 'policy facts' over the 'intent facts' there must be added the caveat that, where the insurance contract itself does not reflect the instructions of the parties, as where an agent, on his own initiative, inserts a reservation of right to change a beneficiary contrary to the intentions which had been expressed to him, no incidents of ownership are thereby created. (Citations omitted.)

Id. at 13.

In Estate of Fuchs v. Commissioner, supra, the Tax Court held that facts were within the exception referred to in Rhode Island Hospital Trust Co., supra. In Estate of Fuchs, each of two partners had obtained insurance on decedent-partner's life to fund a buy-sell agreement. The policies specifically provided that the respective beneficiaries were the sole owners of the policies and the partnership agreement provided that each partner was to have the incidents of ownership of the policies he had obtained. Subsequently, additional policies were issued and the insurance agent was instructed that the beneficiaries were to be the owners of the respective policies. The policies at issue, however, mistakenly gave the decedent-partner some of the incidents of ownership in the policies of the two partners. The court determined that it was the agreement, belief, and understanding of the partners that each insurance policy would be owned by its respective beneficiary and that no right, title, or privilege in the policy was to rest with the insured decedent-partner. The court stated:

> In the case before us, Miller (the partners' insurance agent) failed to effectuate the partners' explicit directions and intentions and, consequently, the Continental Casualty policies similarly failed to reflect clearly those directions and intentions. We cannot see any distinction between the situation where an agent gratuitously adds an unwanted clause in an insurance policy and the situation presented herein where the agent fails to include a desired provision or remove an undesired one. We have no doubt that had the partners been aware of their agent's error in failing to have the insurance policies reflect their wishes, the policies could have been corrected by reformation.

47 T.C. at 205-206.

The court concluded that the insurance contracts at issue were mistakenly drawn up in a manner that did not reflect the intent of the parties. Accordingly, the insurance proceeds were not includible in the decedent-partner's estate. 47 T.C. at 206.

In the present case, we must decide whether the policy facts or the intent facts control for purposes of determining whether the reformation and assignment of the Joint and Survivor Insurance Policy to reflect the Trust as owner will constitute a transfer subject to gift tax or will cause the proceeds to be includible in the estates of Husband and Wife if either dies within 3 years of the assignment.

As in Estate of Fuchs, the intent of the parties in the present case with respect to the ownership of the policies is set forth in contemporaneous instruments. In Estate of Fuchs, the partnership agreement revealed that the partners intended that any partner who obtained an insurance policy on another partner would be considered the owner of that policy. In the present case, the "Transfer by Gift" instrument reveals that Husband and Wife intended to transfer ownership of the insurance policies to the Trust. The trust instrument executed on the same date supports this conclusion. The facts of the present case are also similar to the facts in Estate of Fuchs in that Husband and Wife instructed Insurance Agent to title the new policies in the Trust's name. Insurance Agent failed to follow their instructions and ownership of the policies was not properly recorded. For these reasons, we have determined that the exception articulated in Rhode Island Hospital Trust Co., supra, applies to the facts of the present case. Accordingly, we conclude for gift and estate tax purposes that Husband transferred the Individual Policy of Husband and Wife transferred the Individual Policy of Wife to the Trust on Date 1.

Although not a part of this request for a ruling, we have decided to rule on the gift tax consequences of the transfer of the policies to the Trust in Year 1, for purposes of sound tax administration. In Year 1, Husband and Wife transferred their respective life insurance policies to their children's revocable trust with the expectation that the transfers would be considered transfers of present interests to each of their children. Furthermore, after they both consented to split their gifts pursuant to § 2513, Husband and Wife expected that a total of $d would be excluded in determining the total amount of gifts of Husband and Wife for Year 1 under § 2503(b). Finally, because the amount of the note from the Trust equaled the difference between the combined value of the policies and $d, Husband and Wife expected to owe no gift tax on the transfers of the policies to the Trust in Year 1. A few months later, before any payments were made on the note, Husband and Wife canceled the note from the Trust and forgave the debt. Husband and Wife expected that the forgiveness of the debt would be considered a transfer of a present interest to each of their children in Year 2, and that the amount of each such transfer would be less than the amount excludable under § 2503(b). Thus, Husband and Wife anticipated that no gift tax would result in Year 2 with respect to the forgiveness of the debt owed by the Trust.

We view the initial transfers of the policies, made subject to a deferred debt obligation, and the subsequent forgiveness of such debt obligation a few months later, in a different tax year, without any payments having been made on such debt obligation, as part of a prearranged plan to avoid owing gift tax with respect to the transfers of the policies. Accordingly, we conclude for gift tax purposes that, as part of a prearranged plan, Husband and Wife intended to forgive the note executed by the Trust that was received by Husband and Wife at the time of the transfer of the life insurance policies. See Rev. Rul. 77-299, 1977-2 C.B. 343; Maxwell v. Commissioner, 3 F.3d 591 (2nd Cir. 1993); Deal v. Commissioner, 29 T.C. 730 (1958). See also Harwood v. Commissioner, 82 T.C. 239, 258 (1984).

Thus, we rule as follows:

1. The reformation or assignment of the policy to reflect the Trust as the owner of the policy will not constitute a transfer subject to gift tax under § 2512.

2. The reformation or assignment of the policy to reflect the Trust as the owner of the policy will not cause the proceeds of the policy to be includible in the gross estate of

either Husband or Wife under § 2035 if he or she dies within three years of the reformation or assignment.

3. The note given to Husband and Wife in Year 1 by the Trust is not considered adequate and full consideration in money or money's worth for the transfers of the life insurance policies in Year 1 and, thus, Husband and Wife are treated as having made a gift in Year 1 in the amount $c, the amount of the note.

Since neither Husband nor Wife have yet filed Forms 709 for Year 1, Husband and Wife should expeditiously file individual Forms 709 for Year 1 with the Internal Revenue Service Center, Cincinnati, Ohio 45999, in order to: (a) report the gifts made by each spouse in Year 1 and (b) to signify his and her consent to consider the gifts made by one spouse to be considered as made one-half by each spouse in accordance with § 2513. See § 25.2513-2(b)(1)(i). A copy of this letter should be attached to each Form 709. A copy is enclosed for this purpose.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

James F. Hogan
Senior Technician Reviewer, Branch 9
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosure:
Copy of letter for § 6110 purposes
Copy of letter