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Treasury Greenbook: Technical Guide to the Administration's Proposed Budget

On May 11, 2009, the U.S. Treasury Department released the **General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals** (Greenbook) to "provide details of plans to cut taxes for small businesses and middle class families and close unfair corporate tax loopholes." The Greenbook plans to target "valuation games played by those facing estate and gift taxes that allow them to undervalue transferred property." The following highlights a portion of the items possibly effecting charitable gifting and estate planning:

Transfer-for-Value Rule. The Administration is also proposing changes to the transfer-for-value rule and its exceptions. There is some talk that individuals are using the exceptions to the transfer-for-value rule in order to avoid the taxation that would otherwise be imposed by the transfer-for-value rule. To correct this, the Administration proposes changing the safe harbor exceptions to the transfer-for-value rule to ensure that none of the safe harbors apply to "buyers of policies." When the policy benefits are paid out, the insurer would be required to report, both to the IRS and to the payee, the gross policy benefit, the buyer's TIN, and the insurer's estimate of the buyer's basis. If this proposal were enacted it would apply to sales of interests in life insurance policies and payments of death benefits for taxable years beginning after December 31, 2010.

Valuation Discounts. The Administration is also looking to enforce the valuation rules of Section 2704. Under §2704(b), "applicable restrictions" on interests in family controlled entities are disregarded for valuation purposes. The Administration is concerned that restrictions which should be disregarded for valuation purposes are being recharacterized so that they fall outside the scope of §2704(b), thereby allowing the taxpayer to avoid the application of §2704(b). In order to prevent this abuse, the Administration proposes a new category of "disregarded restrictions," which would not be taken into account when determining the value of the interest in a family controlled entity. Restrictions would be disregarded if, after the transfer the restriction will lapse or may be removed by the transferor or the transferor's family. Disregarded restrictions would also include: (i) limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in the regulations; and (ii) any limitation on a transferee's ability to be admitted as a full partner or holder of an interest in the entity. Under the proposal, an "attribution" rule would deem certain interests held by charities or other non-family members as being held by family members for purposes of determining whether a restriction may be removed by members of the transferor's family. If it were enacted, this proposal would apply to transfers after the date of enactment to property subject to restrictions created after October 8, 1990 (the date §2704 became effective).

Grantor Retained Annuity Trusts (GRATs). The Administration has also turned its attention to grantor retained annuity trusts (GRATs) which traditionally come with a fair amount of risk to the taxpayer/grantor because if the grantor does not outlive the GRAT term, the value of the assets is included in the grantor's taxable estate. In order to minimize this risk but still take advantage of the wealth-shifting aspects of a GRAT, planners and their clients began adopting short term (2-year) GRATs. The Administration sees this as an abuse of the tax provisions creating and controlling GRATs and as a result has proposed a limit to the term available for GRATs. Under the Administration's proposal, all GRATs would have to have a minimum term of 10 years. If enacted, the proposal would apply to all GRATs created after the date of enactment.

Reporting Purchases of Life Insurance. The Obama Administration has added provisions to the proposed FY 2010 Budget that address several perceived abuses taxpayers are employing in order to avoid taxation. Those proposed changes to the tax code include a change to the tax-free nature of life insurance death benefits. The administration has proposed a requirement that a person or entity who purchases an interest in an existing life insurance contract with a death benefit in excess of 1,000,000 must report: (i) the purchase price; (ii) the buyer's taxpayer identification number (TIN); (iii) the seller's TIN and the issuer; and (iv) the policy number. The purchaser would have an obligation to report this information to the IRS, the insurer, and the seller. If this proposal were to be enacted it would apply to sales of interests in life insurance policies and payments of death benefits for taxable years beginning after December 31, 2010.

IRS Posts Life Settlement Rulings: *Rev. Rul. 2009-13*

In this Revenue Ruling, the Service set out to establish the amount and character of an individual's income recognized upon the sale of surrender of life insurance contracts, as described in certain types of situations. Officials describe 3 examples, involving:

1. A policyholder who is also the insured. The policyholder surrenders a policy from a U.S. insurer in policy Year 8. The policy has a cash surrender value of $78,000.
2. A policyholder who sells a similar policy Year 8.
3. A policyholder who sells a policy with no cash value in policy Year 8.

Situation 1: On January 1 of Year 1, A was the insured on a life insurance contract with a member of A's family named as the beneficiary. A had the right to change the beneficiary, to take out a policy loan, or surrender the contract for its cash surrender value. On June 15 of Year 8, A surrendered the contract for its $78,000 cash surrender value, which reflected the subtraction of $10,000 of "cost-of -insurance" charges collected by the issuer for periods ending on or before the surrender of the contract. A had paid premiums totaling $64,000 with regard to the life insurance contract. A had not received any distributions from the contract and had not taken a loan against the policy's cash surrender value.

The Service held that A's income upon surrender of the contract is determined under §72(e)(5). Under §72(e)(5)(A), the amount received is included in gross income to the extent that it exceeds the investment in the contract. A's "investment in the contract," as determined by §72(e)(6) was $64,000; consequently, A recognized $14,000 of income on the surrender of the contract, which is the excess of $78,000 received over $64,000.

As determined by Rev. Rul. 64-51, the proceeds from the surrender of a life insurance contract constitutes ordinary income to the extent that such proceeds exceed the cost of the policy. Therefore, A has $14,000 of ordinary income resulting from the surrender of a life insurance contract on A's life.

Situation 2: The facts are the same as in Situation 1, except that on June 15 of Year 8, A sold the life insurance contract for $80,000 to B, a person unrelated to A and who would suffer no economic loss upon A's death.

The Service held that it is necessary to determine A's amount realized from the sale and A's adjusted basis in the contract. Under §1001(b), A's amount realized from the sale of the life insurance contract is the sum of money received from the sale, or $80,000. Under §§1011 and 1012, the adjusted basis for determining gain or loss is generally the cost of the property, adjusted as provided in §1016. Section 1.1016-2(a) says that §72 has no bearing on the determination of the basis of a life insurance contract that is sold, because §72 only applies to amounts received under the contract.

The Service then held that in order to measure a taxpayer's gain upon the sale of a life insurance contract it is necessary to reduce basis by that portion of the premiums paid for the contract for the provision of insurance before the sale of the contract. The Service found that the cost of the policy is not the total amount paid in premiums, since continuing insurance protection is part of the consideration for the contract. The part of the premiums which represents annual insurance protection has been earned and used and must therefore be subtracted from the taxpayer's basis in the contract.

In Situation 2, A paid total premiums of $64,000 under the life insurance contract through the date of the sale, and $10,000 was subtracted from the contract's cash surrender value as cost-of-insurance charges. Accordingly, A's adjusted basis in the contract as of the date of sale, under §§1011 and 1012, was $54,000. A must recognize $26,000 on the sale of the insurance, which is the excess of the amount realized on the sale ($80,000) over A's adjusted basis ($54,000).

The Service then turned to establishing the character of the $26,000 gain A recognized on the sale of the insurance. The Service held that some or all of the gain on the sale may be ordinary income if the "substitute for ordinary income doctrine" applies. In the case of a sale of a life insurance policy, the Service held that the substitute-for-ordinary income doctrine is limited to the amount that would have been recognized as ordinary income if the contract were surrendered (i.e. to the inside buildup under the contract). Therefore, if the gain recognized on the sale of a life insurance contract exceeds the "inside buildup" under the contract the excess may qualify as gain from the sale or exchange of a capital asset. In Situation 2, the inside buildup under A's life insurance contract immediately prior to the sale to B was $14,000 ($78,000 cash surrender value less $64,000 aggregate premiums paid). That makes $14,000 of the $26,000 is ordinary income to A and the remaining $12,000 is capital gains to A.

Situation 3: The facts are the same as in Situation 1, except that the contract was a level premium fifteen year term life insurance contract without any cash surrender value. The monthly premium for the contract was $500. Through June 15 of Year 8, A paid premiums totaling $45,000 with regard to the contract. On June 15 of Year 8, A sold the life insurance contract for $20,000 to B, a person unrelated to A and who would not suffer economic loss upon A's death.

The Service held that in Situation 3, the amount realized from the sale of the term life insurance contract is the sum of money received from the sale, or $20,000. A's adjusted basis in the life insurance contract for purposes of determining its gain or loss on sale is equal to the total premiums paid under the contract, less charges for the provision of insurance before the sale. The cost of insurance provided to A each month is presumed to be equal to the monthly premium under the contract or $500. The cost of the insurance protection provided to A during the 89.5-month period that A held the contract was $500 times 89.5 months or $44,750. Therefore, A's adjusted basis in the contract on the date of the sale to B was $250 ($45,000 total premiums paid, less 44,750 cost-of-insurance protection).

Accordingly, the Service held that A must recognize $19,750 of gain on the sale of the term life insurance

contract to B, which is the excess of the amount realized ($20,000) over A's adjusted basis ($250). The term life insurance contract held no cash surrender value, so there was no buildup under the contract to which the substitute for ordinary income doctrine could apply. Therefore, the $19,750 of income that A must recognize on the sale of the contract is long-term capital gain within the meaning of §1222(3).

Discounts Granted to S-Corporation Interests

Estate of Marjorie Litchfield et al. v. CIR

Facts: Decedent's estate held interests in two closely held S-corporations, LRC and LSC. LRC had a net asset value of $33,174,196 with built-in capital gains of $28,762,306 and LSC's net asset value was $52,824,413 with $38,984,799 of built-in capital gains.

The estate's valuation expert discounted the estate's 43.1% stock interest in LRC by 17.4% for built-in capital gains taxes, 14.8% for lack of control, and 36% for lack of marketability, giving LRC a fair market value of $6,475,000. For LSC, the estate's expert applied a 23.56% discount for built-in capital gains, an 11.9% discount for lack of control and a 29.7% discount for lack of marketability, giving the estate's 22.96% interest in LSC a fair market value of $5,748,000.

The Service audited the decedent's estate tax return and valued the estate's interest in LRC at $10,300,207 ($3,825,207 higher than the value determined by the estate's expert) and in LSC at $8,762,783 ($3,014,783 higher than the value reported by the estate). After paying the estate tax deficiency found by the Service, the estate filed suit for a refund for overpayment of estate taxes. The estate and the Service agreed as to the net asset value of both LRC and LSC, leaving the Tax Court to determine the discount that should be used for built-in capital gains taxes, lack of control and lack of marketability.

Ruling: The Tax Court emphasized that the resolution of valuation issues typically involves an approximation of value and that the value reached by the Court does not need to be tied to specific testimony or evidence if it is within the range of values supported by the evidence. When discussing the nature and applicability of the various discounts at issue in this case, the Court pointed out that knowledgeable buyers would negotiate discounts in the price of the stock to estimate, on the basis of current tax laws, the corporate capital gain liabilities due upon sale or disposition of the corporation's assets, as well as the standard lack-of-control and minority interest discounts.

After establishing the valuation methodology, the Court compared the two valuation reports. For the built-in gains discount, the estate's expert consulted with the officers and board of directors of LRC and LSC concerning their plans for selling the corporation's assets, reviewed board meeting minutes and tracked historical asset sales. In contrast, the Service's expert based his built-in capital gains discount solely on LRC and LSC's historical asset sales. The Court held that the expert's assumptions relating to asset turnover were based on more accurate data and accepted the estate's expert's built-in gains discounts of 17.4% and 23.6%, for LRC and LSC, respectively.

Both experts calculated similar lack-of-control discounts for LRC's farmland and related assets and used lower lack-of-control discounts for LRC's securities. However, the estate's expert used a weighted average to account for the fact that LRC has significantly more farmland than securities, whereas the Service's expert used a straight average. Because of the Service's expert's failure to take into account the difference between LRC's assets, the Court held that the estate's expert's 14.8% lack-of-control discount for the estate's LRC minority stock interest is appropriate. The Service's expert applied the same 5% discount to LSC's securities as he applied to LRC's securities, even though the estate's 22.96% interest in LSC was significantly smaller than its interest in LRC. Because the Service's expert failed to consider the smaller holding in LSC, the Court held that the estate's expert's 11.9% lack-of-control discount for LSC was appropriate.

The Court found that the estate's expert's respective 36% and 29.7% discounts for LRC and LSC were high and stated that the estate's expert used some outdated data relating to restricted stock discounts, resulting in higher marketability discounts than those reflected in benchmark studies that included all components of lack-of-marketability discounts. The Court concluded that discounts for lack of marketability of 25% and 20% should apply to the estate's respective LRC and LSC minority stock interests. The Court found that the estate's 43.1% interest in LRC was worth $7,546,725, and its 22.96% interest in LSC was worth $6,530,790. Those respective values were $1,071,725 and $782,790 higher than the estate's expert calculated, but were $2,753,482 and $2,231,993 less than the values determined by the Service's expert.