

## **Rev. Rul. 2011-28**

### **ISSUE**

Whether a grantor's retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held by a trust by substituting other assets of equivalent value will cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042 of the Internal Revenue Code.

### **FACTS**

D, a United States citizen, established and funded Trust with cash. Thereafter, Trust purchased a life insurance policy on D's life. Trust is an irrevocable trust for the benefit of D's descendants. T is the trustee of Trust, and the terms of Trust prohibit D from serving as trustee of Trust. D makes gifts every year to Trust, and Trust pays the premium on the insurance policy. The proceeds of the policy are payable to Trust upon D's death.

D cannot revoke, alter, amend, or terminate the trust. The governing instrument of Trust, however, provides D with the power, exercisable at any time, to acquire any property held in Trust by substituting other property of equivalent value. The trust instrument provides that the power is exercisable by D in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. To exercise the power of substitution, D must certify in writing that the substituted property and the Trust property for which it is substituted are of equivalent value. In addition, under local law, T has a fiduciary obligation to ensure that the property that D seeks to substitute is equivalent in value to the property distributed to D. Moreover, if a trust has two or more beneficiaries, local law requires the trustee to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Finally, under local law and without restriction in the trust instrument, T has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law.

D has no incidents of ownership in the insurance policy unless D's right of substitution is considered an incident of ownership. D dies without having exercised the power to substitute with respect to the life insurance policy.

## LAW AND ANALYSIS

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

Section 20.2042-1(c)(2) of the Estate Tax Regulations provides that the meaning of the term "incidents of ownership" is not confined to ownership of the policy in the technical legal sense. Generally speaking, the term refers to the right of the insured or the insured's estate to the economic benefits of the policy. Thus, the term includes without limitation 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.

Section 20.2042-1(c)(4) provides that a decedent is considered to have an incident of ownership in a policy held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under § 2036 or 2038 of other property transferred by the decedent to the trust if, for example, the decedent has the power to surrender the insurance policy and if the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.

In Rev. Rul. 84-179, 1984-2 C.B. 195, the decedent purchased an insurance policy on his life and transferred all incidents of ownership to his spouse. His spouse designated their adult child as the policy beneficiary. Subsequently, the spouse died and her will established a residuary trust for the benefit of the child. The decedent was designated the trustee of this trust. The insurance policy on the decedent's life, which was part of the residuary estate, passed to the testamentary trust. As trustee, the decedent had broad discretionary powers in the management of the trust property and the power to distribute or accumulate income. Under the terms of the policy, the owner could elect to have the proceeds made payable according to various plans, use the loan value to pay the premiums, borrow on the policy, assign or pledge the policy, and elect to receive annual dividends. The will did not preclude the decedent from exercising these powers, although the decedent could not do so for his own benefit. The decedent paid the premiums on the policy out of other trust property and was still serving as trustee when he died.

Citing the legislative history of § 2042(2), the ruling states that Congress intended § 2042 to parallel the statutory scheme governing those powers that would cause other types of property to be included in a decedent's estate under §§ 2036 and 2038. Section 2036 applies to the transfer of property where rights or powers are retained incident to the transfer, and § 2038 pertains to situations where property is transferred and power over the property subsequently returns to the transferor-decedent.

Under the facts in Rev. Rul. 84-179, the decedent transferred the policy to his wife and subsequently, in an unrelated transaction, reacquired incidents of ownership over the policy in a fiduciary capacity. The ruling holds that the decedent will not be considered to possess incidents of ownership in the policy for purposes of § 2042(2), provided the decedent could not exercise the powers for the decedent's personal benefit, the decedent did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the powers to the decedent was not part of a prearranged plan involving the participation of decedent.

The ruling further states, however, that the decedent will be deemed to have incidents of ownership over an insurance policy on the decedent's life where decedent's powers are held in a fiduciary capacity and the decedent has transferred the policy or any of the consideration for purchasing and maintaining the policy to the trust. Also, where the decedent's powers could have been exercised for decedent's benefit, they will constitute incidents of ownership in the policy, without regard to how those powers were acquired and without consideration of whether the decedent transferred property to the trust. Thus, in such a situation, if the decedent reacquires powers over insurance policies in an individual capacity, the powers will constitute incidents of ownership even though the decedent is a transferee. See *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970); *Estate of Skifter v. Commissioner*, 468 F. 2d 699 (2d Cir. 1972).

In *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), acq. in result, 1977-2 C.B. 1, the decedent created an inter vivos trust. The corpus of the trust included insurance policies on the decedent's life and other income producing assets. Under the terms of the trust, the decedent reserved the power to substitute other securities or property for those held in trust, provided the substituted property was equal in value to the property replaced. After the decedent's death, the Service argued that the trust assets were includible in the decedent's gross estate under § 2038 because the decedent's power to substitute assets of equal value could be exercised to alter the beneficial interests in the trust. The Service also argued that the proceeds from the insurance policies should also be included under § 2042(2) because the power to substitute the insurance policies allowed the decedent to reacquire full ownership of the policies in the trust.

The Tax Court determined that, because the decedent was bound by fiduciary standards and was therefore accountable in equity to the succeeding income beneficiary and remaindermen, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries. Accordingly, the Court held that the substitution power was not a power to alter, amend, or revoke the trust within the meaning of § 2038. The court further concluded that the decedent's power to substitute an insurance policy was merely a power to exchange at arm's length. The Court held that such a power was in effect a right to purchase the policy and that such a right could not be considered an incident of ownership.

In Rev. Rul. 2008-22, 2008-16 I.R.B. 796, the grantor created an irrevocable inter vivos trust for the benefit of the grantor's descendants. The grantor retained the power, exercisable in a nonfiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value. The ruling concludes that the grantor's retained power to substitute assets of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value. The ruling further provides that the substitution power cannot be exercised in a manner that would cause the shifting of benefits among the trust beneficiaries.

In the instant case, like the situation presented in Rev. Rul. 2008-22, the trust instrument expressly prohibits D from serving as trustee and states that D's power to substitute assets of equivalent value is held in a nonfiduciary capacity. However, under the terms of Trust, the assets that D may transfer into Trust must be equivalent in value to the insurance policies that D will receive. In addition, T has a fiduciary obligation to ensure that the assets substituted are of equivalent value. Thus, D cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase D's net worth. Further, in view of T's ability to reinvest the assets and T's duty of impartiality to the trust beneficiaries, there will be no shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by D. Under these circumstances, D's retained power to substitute assets of equivalent value for a life insurance policy held by Trust is not, by itself, an incident of ownership under § 2042(2).

## **HOLDING**

A grantor's retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042, provided the trustee has a fiduciary obligation (under local law or

the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

### **DRAFTING INFORMATION**

The principal author of this revenue ruling is Mayer Samuels of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Samuels at (202) 622-3090 (not a toll-free call).