

Understanding Transfer for Value—

A Trap for the Unwary

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Overview

The purpose of this publication is to describe some of the issues surrounding the transfer for value rule. It explains the basic rule and some of the corollary issues arising out of the application of the rule. In addition, it describes some common estate planning and buy sell situations in which the transfer for value rule becomes a problem.

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The Transfer for Value Rule

Section 101(a) of the Internal Revenue Code generally treats the receipt of death proceeds of a life insurance policy as income tax free to the beneficiary. The law also provides for a very important exception to that treatment. The exception is called the “transfer for value” rule.

The transfer for value rule is relatively straightforward: if a life insurance policy is sold or transferred in exchange for valuable consideration then the receipt of the death benefit will be subject to income tax.¹ Tax will be due on the amount received as a death benefit less the amount paid for the policy (the consideration) and less any premiums subsequently paid by the transferee. The beneficiary is responsible for the payment of the tax.

¹ IRC Section 101(a)(2).

Exceptions To The Rule

The transfer for value rule is subject to a number of exceptions. If the transfer is to:

1. the insured; or
2. a partner of the insured; or
3. a partnership in which the insured is a partner; or
4. a corporation in which the insured is a shareholder or an officer;

then the transfer for value rule will not apply and the entire death benefit should be received income tax free.²

An additional exception to the transfer for value rule applies in situations where the basis of the policy in the transferee’s hands is determined in whole or in part by reference to its basis in the hands of the transferor.³ This exception applies to those situations in which a policy is transferred in part as a gift and in part for valuable consideration. For illustrations of this sort of transfer, please read the second and third examples discussed later under the heading “Estate Planning Examples.”

Note that a true gift of a life insurance policy should not trigger the transfer for value rule. By its very definition a gift is a one way transaction – no exchange of valuable consideration is expected by the person making the gift. In addition, a gift falls within an exception to the transfer for value rule – as the donee’s basis in the policy is determined by reference in its basis in the hands of the donor.

Corollary Issues

There are a number of closely related questions which arise under the transfer for value rule. Let’s turn to them.

² IRC Section 101(a)(2)(B)

³ IRC Section 101(a)(2)(A)

- **Transfer of Less than an Entire Policy**

Does an entire policy have to be transferred for the transfer for value rule to be violated?

No. The transfer for value rules applies to the transfer for valuable consideration of any interest in a life insurance policy.⁴

The policy interest transferred could be a partial interest or any incident of ownership. For example, naming a policy beneficiary in exchange for valuable consideration will constitute a transfer for value.

- **Value Other Than Cash**

Is the consideration given in exchange for the interest in a policy limited to cash?

No. Valuable consideration that can trigger the transfer for value rule can take a variety of forms.⁵ For example, where a corporation transfers a key person policy to a co-shareholder of the insured, to be used to fund a cross purchase buy-sell agreement, the transfer for value rule is violated. What was the valuable consideration given in exchange for the policy? In this example, there are two possible answers. First, the corporation might have transferred the policy to the co-shareholder as compensation, and compensation is generally consideration. Second the value to the shareholder of executing and funding the buy-sell agreement is a form of consideration. For a more detailed explanation of this example, please read the examples discussed later under the heading “Buy-Sell Examples”.

- **Transfer of a Term Policy**

Does the transfer for value rule apply only to the transfer of whole life policies

(including variable life policies) or does it also apply to the transfer of term policies?

The transfer for value rule does apply to the transfer of interest in term policies for valuable consideration.⁶

- **Tainted Forever?**

Once a policy is tainted by the transfer for value rule does it stay tainted forever?

Not necessarily. If the policy is subsequently transferred to a party who falls into an exception to the transfer for value rule, then the policy is no longer tainted.⁷

For example, if an insured sells her policy to her brother and subsequently dies, then the policy is subject to the transfer for value rule – and the applicable amount of death proceeds from the policy would consequently be subject to income taxation. However, if the brother gifts or sells the policy back to the insured before she dies, then the policy is no longer tainted because transferring the policy to the insured is an exception to the transfer for value rule. The final owner and transfer are the ones that count for the transfer for value rule.⁸

- **Transfer Pursuant to a Divorce Settlement**

If a policy is transferred to a spouse or to an ex-spouse under the terms of a divorce settlement; will that transfer be considered a transfer for value? Prior to the passage of the Tax Reform Act of 1984, such a transfer would have violated the transfer for value rule. Now, however, Section 1041 of the Internal Revenue Code states that transfers under a divorce settlement or any transfers to

⁴ IRC Section 101(a)(2)

⁵ Montrose v. Patterson, 197 F.Supp. 146 (N.D. Ala. 1961).

⁶ IRC Section 101(a)(2) makes no distinction between whole life and term products.

⁷ Treasury Regulations Section 1.101-1(b)(3).

⁸ Treasury Regulations Section 1.101-1(b)(3).

a spouse are considered a gift (even if there is actual consideration passing to the transferor spouse). The transferor's basis thus becomes the transferee's basis, and the transfer itself falls into one of the exceptions to the transfer for value rule.⁹

Common Estate and Buy Sell Planning Examples

Estate Planning Example 1: Sale of Policy to Child

Mom has a life insurance policy with a death benefit of \$500,000 and a cash surrender value of \$50,000. Mom sells the policy to her Son for \$50,000 in cash. Does this exchange violate the transfer for value rule? Yes.

Mom transferred an interest in a life insurance policy in exchange for valuable consideration, and Son does not fit into any of the exceptions to the transfer for value rule.

In any case, Son now owns the policy on Mom. Son pays an additional \$25,000 in premiums on the policy. Mom dies. We know that the transfer for value rule has been violated and that the death benefit is subject to income taxation. Exactly how much of the \$500,000 death benefit is taxable? Son must pay income tax on \$425,000 (\$500,000 received as death benefit minus \$50,000 of consideration paid for the policy and minus \$25,000 of premiums subsequently paid by Son).

Estate Planning Example 2: Transfer of Policy with Outstanding Nonrecourse Loan to Child

Let's change the facts a little bit. Mom still has a life insurance policy with a death

benefit of \$500,000. In this instance, however, that policy has an outstanding loan of \$110,000 secured by the value of the policy itself. Mom transfers the policy to Son, and Son makes no cash payment to Mom. Mom is no longer liable for the loan. Has the transfer for value rule been violated? Yes.

Son has given Mom valuable consideration in exchange for the policy. What was that consideration? Accepting the policy with the outstanding loan.

Let's look at this concept a bit more closely. How was Son's acceptance of the policy with an outstanding loan valuable consideration to Mom? To understand the value to Mom, put yourself in her shoes: before you transferred the policy, you owed the life insurance company \$110,000 and, after Son took the policy off of your hands, you didn't owe the life insurance company anything – Son did. Son's acceptance of the obligation to repay the debt is valuable consideration to Mom.

Could Son in this example fit into one of the exceptions to the transfer for value rule? Is the son the insured? No. Is the transfer to a partnership or a corporation? No. Is the son a partner of the insured? No. Remember that another exception exists where the basis of the policy in the transferee's hands is determined wholly or partly by reference to its basis in the hands of the transferor. Assume that Mom's basis in the policy was \$120,000. In that case, it looks as though the value of the policy exceeds the value of the loan. In other words, Son acquired the policy from Mom as part sale and part gift. Because Mom's basis (\$120,000) was greater than the amount of the loan (\$110,000), the basis of the policy in Son's hands is determined at least in part by looking to Mom's basis. Therefore, this transaction fits into an exception to the transfer for value rule. However, if Mom's basis was only \$100,000,

⁹ IRC Section 101(a)(2)(A).

no exception would apply and the proceeds would be subject to income tax.

As a general rule of thumb in these instances: *Where the loan amount is larger than the transferor's basis in the policy, there is a transfer for value; where the loan amount is smaller than the transferor's basis in the policy, there may not be a transfer for value.*

WARNING: this is a complex area. If you have a client who wants to transfer a policy subject to a loan, then you have a potential transfer for value problem. The best thing to do in these instances may be to discharge the loan before transferring the policy to a point where the basis exceeds the loan.

Estate Planning Example 3: Transfer of Policy with an Outstanding Loan to Irrevocable Trust

What happens if Mom from the last example transfers her \$500,000 policy with an outstanding \$110,000 loan to an irrevocable life insurance trust? As in the last example, there is a potential transfer for value. The trustee of the trust has accepted a policy with an outstanding loan, and this acceptance is valuable consideration to Mom. All of the issues discussed in the last example also arise here. They are in no way diminished by the substitution of an irrevocable trust for Son as transferee.

Buy-Sell Example 1: Transfer of Corporate Policies to Shareholders

Two shareholders, Bill and Al, each own 50% of the stock of a corporation. The corporation owns key person policies on each of Bill and Al. Bill and Al have executed a cross purchase buy sell agreement and, to fund the agreement, have caused the corporation to transfer the policy on the life of Bill directly to Al and to transfer to the policy on the life of Al directly to Bill.

Do these transfers of corporate owned policies to a co-shareholder of the insured violate the transfer for value rule? Yes, for two reasons. First the transfer of the policies might be viewed as a form of compensation for services rendered by a shareholder/employee to the corporation. Second, entering into the cross purchase buy sell agreement itself creates value: the execution of the agreement is valuable to the corporation and shareholders because it provides for the future stability of the corporation. **Note that co-shareholders are not an exception to the transfer for value rule.**

Buy-Sell Example 2: Transfers of Policies Between Co-Shareholders

Would the result of the last example change if the policies were originally owned by the insureds? How would that look? Bill owns a policy on his own life, and Al owns a policy on his own life. Bill and Al execute a cross purchase buy sell agreement and transfer their individually owned policies to each other to fund that buy sell. Do these transfers of individually owned policies to a co-shareholder of the insured violate the transfer for value rule? Yes. Entering into the buy sell agreement provides value to both Bill and Al and both Bill and Al receive consideration for transferring his insurance policy (the policy on the other). Again, no exception applies since co-shareholders are not an exception to the transfer for value rule.

In this instance, Bill and Al could transfer their policies to the corporation to fund a stock redemption agreement. Remember that a corporation in which the insured is a shareholder or an officer is an exception of the transfer for value rule.

Buy-Sell Example 3: Corporate Cross Purchase Among More than Two Shareholders

Let's change the facts of our example a bit. There are now three shareholders in the corporation, Bill, Al and Hillary. Bill, Al and Hillary have executed a cross purchase buy sell agreement; and, to fund that agreement, each buys policy on each of the other two. For instance, Bill owns a policy on each of Al and Hillary. All of these policies are new policies, and the transfer for value rule has not yet been triggered. (Note: the purchase of the policies were made subsequent to the signing of the cross purchase agreement.)

What happens if one of the shareholders dies? Assume that Bill dies. Because Al and Hillary want to continue the cross purchase arrangement between themselves and want to utilize the existing policies, Al purchases from Bill's estate the policy that Bill held on Hillary, and Hillary purchases from Bill's estate the policy Bill held on Al. Do these purchases violate the transfer for value rule? Yes. Co-shareholders are not exceptions to the transfer for value rule. Note that – even if these policies had not been purchased from Bill's estate for cash – there could have been a transfer for value. The transfer of the policies could be consideration for the sale of Bill's stock.

Would the results of this example change if Bill, Al, and Hillary had jointly owned policies on each other? No. Al and Hillary would still need the coverage provided by Bill's interest in the two existing policies to continue the cross purchase arrangement, and a transfer of any interest in a policy will trigger the transfer for value rule. Would the results of this example change if the shareholders were named as contingent owners on the policies so that there would be an automatic transfer to Al and Hilary of

Bill's interest in the policies upon his death? No. How about if the policy interest were "gifted" to Al and Hillary? Again, no. Both a contingent ownership designation and a "gift" are transfers, and having entered into the buy sell agreement in the first place would have created value.

The most obvious way to avoid the transfer for value problem which arises after the first death in a cross purchase agreement among more than two shareholders is to implement a stock redemption arrangement instead. Remember, a transfer of a policy to a corporation where the insured is an officer or shareholder is an exception. Another solution is to buy a little extra insurance to pay the buy out price and pay income tax on any policy interest that have been transferred for value. One might also be able to solve the problem through the use of a partnership (Please see question 4.)

Buy-Sell Example 4: Transfers of Policies Involving Partnerships

The last three examples have related to buy sell arrangements in a corporate setting. The transfer for value rule was a problem in each of those examples because co-shareholders are not an exception to the transfer for value rule. What about the transfer of policies in a partnership setting?

The transfer for value rule is less likely to be a problem when a partnership is involved. Both (i) a partnership in which the insured is a partner and (ii) a partner of the insured are exceptions to the transfer for value rule. As a consequence, policies can be transferred from a partnership to a partner of the insured and vice versa without violating the transfer for value rule; and policies can be transferred among partners without violating the transfer for value rule.

The partners and partnership exceptions should apply even in instances in which the partners are also co-shareholders. For instance, assume that Bill, Al and Hillary from the last example are also partners in a partnership which invests in real estate. Their status as partners should protect their transfer of policies – even though they transferred the policies in conjunction with a corporate buy sell arrangement.¹⁰

A word of caution must, however, be sounded here. A partnership which has been created solely for the purpose of holding insurance policies or for circumventing the transfer for value rule may not protect one from the application of the transfer for value rule. Although the Internal Revenue Service may be becoming more liberal in this area¹¹, the partnership and partner exceptions are most likely to apply in instances in which a real partnership with an independent business purpose exists.

Buy-Sell Example 5: Transfers of Policies Involving the Members of A Limited Liability Company

Will a transfer to a limited liability company or the members of a limited liability company fall within the partnership exception? The LLC is treated as a partnership and the members are treated as partners for income tax purposes. It is then arguable that partnership treatment should be allowed for the purposes of the transfer for value rule. Thus far the IRS has ruled in a PLR that members of a LLC are treated as partners for the transfer for value purposes under IRA Section 101(A)(2).¹² Ultimately, this

determination should be made by the client's legal and tax professional advisors.

Conclusion

While the transfer for value rule and its exceptions are relatively straightforward, the application of the rule and its exceptions can be complicated. Ignorance of the rule can be a trap for the unwary. To protect your client, check all transfers of life insurance policies and interests in those policies for potential violations of the transfer for value rule. In those cases where policies or interests in policies are transferred or “re-arranged,” please call an attorney in APPS to review potential consequences.

¹⁰ See generally: Private Letter Ruling 9042023 and Private Letter Ruling 9045004.

¹¹ For example, see Private Letter Ruling 9309021.

¹² See Private Letter Ruling 9625014.