



Transfer-for-value rule.

One of the most attractive aspects of life insurance as a financial planning tool is the tax treatment of the proceeds. Generally, the proceeds a beneficiary of a life insurance policy receives by reason of the insured's death are entirely free from income tax (Sec. 101(a)(1)). However, an often overlooked provision of the tax law known as the "transfer-for-value rule" can result in the loss of that favorable tax treatment.

Under the transfer-for-value rule, if a policy (or any interest in a policy) is transferred for a valuable consideration, the death proceeds will generally be excludable from income only to the extent of the consideration paid by the transferee, plus the net premiums paid by the transferee after the transfer (Sec. 101(a)(2)). The balance of the proceeds will be taxable as ordinary income. In other words, a policy that becomes subject to the transfer-for-value rule loses the income tax exemption ordinarily permitted for life insurance proceeds, except to the extent the transferee develops basis in the policy.

Example: Small corporation M has paid premiums totaling \$5,000 for a \$100,000 life insurance policy on the life of shareholder A. In 1992, M transfers the policy to shareholder B (the noninsured shareholder) for \$6,000. B receives the \$100,000 proceeds on A's death in 1994. During the period B owned the policy (1992-1994), he paid premiums totaling \$3,000. The amount B can exclude from income is limited to \$9,000 (the \$6,000 he paid to M for the policy + the \$3,000 of premiums he paid after the transfer). The \$91,000 balance is taxable to B in 1994.

The transfer-for-value rule includes, but goes beyond, outright sales of life insurance policies. For example, the naming of a beneficiary in exchange for any kind of valuable consideration is a transfer for value of an interest in the policy. On the other hand, a pledging or assignment of a policy as collateral is not a transfer for value (Regs. Sec. 1.101-1(b)(4)).

Fortunately, the tax law contains several exceptions to the transfer-for-value rule (Sec. 101(a)(2)(A) and (B)). In the following situations, the proceeds will be exempt from income tax despite a transfer for value.

* A transfer for value to the insured person.

* A transfer for value to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is an officer or shareholder.

* A transfer for value in which the transferee carries over the transferor's basis in the policy in whole or in part; for example, when a policy is transferred from one corporation to another in a tax-free reorganization, or when a policy is acquired in part by gift.

In a series of transfers of the same policy, if the final transfer is a transfer for value, the transfer-for-value rule will apply, and the exclusion generally will be limited to the consideration paid by the transferee, plus any premiums paid by the transferee (Regs. Sec. 1.101-1(b)(3)(i)). If the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the entire proceeds will be tax free (Regs. Sec. 1.101-1(b)(3)(ii)). If none of these exceptions apply and the final transferee carries over the transferor/s basis in whole or in part, the excludable amount is the amount that would have been excludable by the transferor had the transfer not taken place, plus any premiums paid by the final transferee (Regs. Sec. 1.101-1(b)(3)(iii)). These series-of-transfers rules make it possible to correct an earlier "error" in the transfer of a life insurance policy.

It is important to keep the transfer-for-value rule in mind any time a taxpayer is considering the transfer of a life insurance policy. Most transfers among family members are at least part gift, and as

such will usually avoid the application of the rule. Even here, however, the rule may apply if the amount the transferee pays for the Policy--or the amount of a loan to which the policy is subject--exceeds the transferor's basis in the policy. In that case, the transferee's basis in the policy at the time of the transfer will not be a carryover, in whole or in part, of the transferor's basis; rather, the transferee's basis will be based on what he has paid for the policy, which would apparently render the carryover basis exception inapplicable (Regs. Sec. 1.1015-4; IRS Letter Ruling 8951056).

Planning to avoid the transfer-for-value rule

The transfer-for-value rule comes into play most frequently in connection with funding buy-sell agreements, when a life insurance policy is transferred by a corporation to one of the shareholders. For example, in IRS Letter Ruling 9045004, a corporation proposed to facilitate a buy-sell agreement by transferring life insurance policies on two of its shareholders to noninsured shareholders. Because the noninsured and the insured shareholders were also partners in a partnership, the Service ruled that an exception to the transfer-for-value rule applied; therefore, the insurance proceeds were exempt from income tax. If a partnership does not currently exist, one can often be created, perhaps holding assets that the corporation uses in its business.

Other variations on this theme may also be available. One would be to transfer the policies to the partnership rather than to individual partners. Another variation would be to reorganize so that a partnership of the current shareholders owns all the corporate stock. Again, the partnership could own the life insurance policies, avoiding the transfer-for-value problem while maintaining the centralization of the policies without "locking" the proceeds in the corporation. The ownership of an insurance policy by a partnership would limit the estate tax inclusion of the proceeds to the insured partner's percentage of ownership in the partnership.

Often, entities choose to give insurance policies to insured executives on their retirement. If the retiree subsequently transfers the policy to an irrevocable life insurance trust, he faces the risk that the proceeds will be subject to estate tax if he dies within three years of that transfer (Sec. 2035). If, instead, the corporation transferred the policy directly to the executive's stand-alone irrevocable life insurance trust, the transfer-for-value rule would cause all or a part of the proceeds to be subject to income tax. One technique avoids both these problems: First, the trustee of the insured's irrevocable life insurance trust should form a partnership with the insured. Then, the corporation (or other owner of the policy) should transfer the policy on the insured directly to the life insurance trust. Although this is a transfer for value, it qualifies for the exception under Sec. 101(a)(2)(B) as a transfer to a partner in a partnership with the insured. The policy proceeds will not be taxable to the life insurance fund, and if the insured dies within three years of the transfer, the policy proceeds will not be included in the insured's gross estate, since the insured was not the one who transferred the policy to the trust.

Underlying these strategies is the assumption that the partnerships are legitimate, rather than mere nominees for their partners. The entities must meet the definition of partnership under Sec. 7701(a)(2): a partnership is an unincorporated organization through which "any business, financial operation, or venture is carried on . . ."; and Regs. Sec. 301.7701-2(a)(2): a partnership must have "an objective to carry on business for joint profit." The most conservative way to meet this requirement is to conduct separate business activities, such as equipment leasing, in the partnership. Some have suggested that making the partnership a party to a corporate buy-sell agreement may give the partnership a sufficient objective to carry on business for joint profit motive. In any event, this aspect of the transfer strategy deserves special attention.

© Copyright 2008 The Gale Group, Inc. All rights reserved.

© Copyright © 1993 American Institute of CPA's

You may not repost, republish, reproduce, package and/or redistribute the content of this page, in whole or in part, without the written permission of the copyright holder.

 Close Window

Use of this site is governed by our [Terms of Use Agreement](#) , and [Privacy Policy](#) .

Copyright © 1999-2008 AllBusiness.com, Inc. All Rights Reserved