Tax Trap

The Transfer for Value Tax Trap

By Robert J. Adler

An important exception exists to the general rule of Internal Revenue Code § 101 that life insurance proceeds are excluded from the gross income of the recipient. This exception is known as the "transfer for value rule," and it works like this: after the initial issuance of a policy, if it is subsequently transferred for "valuable consideration," the income tax exclusion under IRC § 101(a) is lost, and the beneficiary must include in gross income the proceeds received to the extent that they exceed both the consideration paid by the transferee of the policy and any subsequent premium payments or other costs of maintaining the policy after the transfer.

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Exempting life insurance proceeds from income taxation is based on a rationale that insurance functions as an alleviation of economic hardship flowing from the insured's death. When a policy is "purchased" by one party from another the situation begins to look more like an investment or business type transaction, in which the eventual receipt of the proceeds on the death of the insured is a bargained-for benefit, having no strong policy rationale for exclusion from income of the recipient. Thus, the economic hardship rationale may well be inapplicable in cases in which an insurance policy has been transferred for valuable consideration.

> ***Example***
> John purchases a $750,000 life insurance policy on his own life, naming his brother Tom as the beneficiary. Subsequently, John transfers the ownership of the policy to Tom for $5,000. This is a transfer for value under IRC § 101(a)(2). During the succeeding four years Tom pays annual premiums of $2,000 per year. Thereafter, John dies and Tom receives the $750,000 death benefit under the policy. Because of the transfer for value rule, Tom realizes ordinary income in the amount of $737,000 (the $750,000 proceeds, less the $13,000 which he paid to acquire and maintain the policy).

The Transfer for Value Rule

The transfer for value rule can become a tax trap for unwary advisors and their clients.

Neither Cash Consideration Nor Formal Transfer of Policy Ownership Is Necessary to Trigger Rule

The transfer for value rule can come into play under a variety of circumstances in which a party acquires an interest in the proceeds for some form of valuable consideration. There need not necessarily be a formal transfer or assignment of ownership of the policy. For example, the naming of a beneficiary in exchange for any kind of valuable consideration could constitute a transfer for value. The granting by separate agreement of a right to receive all or part of the death benefit would constitute a transfer for value, as long as consideration is given for such right. Whether or not the policy has a cash value at the time of the transfer for consideration has no bearing on the applicability of the transfer for value rule. A transfer for value can occur even though no purchase price per se is paid for the interest in the policy, as long as the transferor receives some type of valuable consideration.

Pledge of Policy as Collateral

If an insurance policy is pledged as collateral to secure a loan or other obligation, this is not deemed a transfer for valuable consideration and will not generally trigger the transfer for value rule. Thus, if the insured dies owing a debt secured by a pledge of his insurance policy, and the pledgee receives all or a portion of the insurance proceeds in satisfaction or reduction of the debt, such proceeds will not be gross income to the recipient.

Common Situations Involving the Transfer for Value Tax Trap

Transfer of Policy Subject to Policy Loan

If ownership of a life insurance policy is transferred at a time when the policy is subject to a policy loan, even if no other consideration is received for the transfer, it will be deemed a transfer for value. Under the IRS's rationale, in such a situation the transferor realizes consideration in the form of relief from the debt represented by the policy loan. The transferor-taxpayer is considered to benefit from the discharge of the debt on disposition of an asset securing the debt (the life insurance policy), even when the debt is nonrecourse, as is the case with an insurance policy loan. See Treas. Reg. § 1.1001-2(a)(4)(i).

Split-Dollar Plans

If a split-dollar plan is established using an existing policy, or if a policy subject to a split-dollar plan is rolled out to a designee of the employee/insured, there is a potential transfer for value problem.

Buy-Sell Agreements

Because buy-sell agreements are commonly funded with life insurance, and it is sometimes determined to be advantageous to make changes in the ownership of the policies involved, care must be taken to avoid the transfer for value trap in connection with any such transfers.

Purchases and Sales of Businesses

If a business that owns one or more life insurance policies (for example, key man policies) sells its assets, or its assets are transferred in liquidation, it is likely that the policies will be deemed to have been transferred for value, and if retained by the acquiring party until the death of the insured, the death benefit (in excess of the consideration paid for the policy's acquisition and subsequent maintenance) will likely be treated as ordinary income.

Business Contractual Arrangements Requiring Life Insurance

In business arrangements in which the services of a particular individual are of critical importance, it is sometimes required that life insurance be maintained on that individual. Thus, for example, if the insured party acquires and maintains the policy, but is contractually required to name one or more parties as beneficiary(s), the transfer for value rule will come into play, and the death benefit will be taxable to such beneficiary as ordinary income. (This would not be the case, however, if the policy is acquired, and the premiums paid, by the beneficiary.)

Transfer for value problems can be avoided in all of the above situations, and many others, if there is a clear understanding of the statutory exceptions to the transfer for value rule, discussed immediately below.

Statutory Exceptions to the Transfer for Value Rule

IRC § 101(a)(2), which sets forth the transfer for value rule, contains two important exceptions.

Transferor's Basis Exception—IRC § 101(a)(2)(A)

The so-called "transferor's basis exception" provides that the transfer for value rule does not apply when the transferee's basis in the policy is determined

If a policy has been the subject of a transfer for value transaction, and neither of the exceptions to the transfer for value rule is applicable, the death benefit will be subject to taxation as ordinary income.

in whole or in part by reference to its basis in the hands of the transferor. This exception is of greatest importance in the context of policy transfers that constitute, at least in part, gifts.

Transfers That Are Part Sale and Part Gift

When property is transferred by gift, the property takes a "carryover" basis in the hands of the transferee; that is, the transferor's basis is carried over and becomes the basis of the property in the hands of the transferee. Although this exception would eliminate all pure gifts of insurance policies from the application of the transfer for value rule, a pure gift transfer (for no consideration whatsoever) would not be subject to the rule, even absent the exception, because the rule itself only applies when the transfer involves at least some consideration. On the other hand, the exception is important in situations in which a transfer has a gift element, but the transferor receives at least something in connection with the transfer. This is referred to as a part-gift, part-sale transfer. Because the transferor's basis exception to the transfer for value rule operates when the transferee's basis is determined in whole or in part by reference to the transferor's basis, the exception will apply in a part-gift, part-sale situation, because the gift portion of the transfer will involve a carryover basis.

> *Example*
> Bill is the owner of a $500,000 insurance policy on his life. His basis in the policy is $10,000; the cash value of the policy is $12,000. Bill transfers ownership of the policy to his son, Sheldon, for an agreed consideration of $2,500. Bill has made a part-gift, part-sale of the policy, the gift being the excess of the policy's fair market value (measured by the cash value) over the amount paid. Under the carryover basis rule applicable when there is a gift involved, Sheldon's basis in the policy would be $10,000, Bill's basis at the time of the transfer, even though Sheldon paid only $2,500 for the policy. Even though there was a transfer of the policy for valuable consideration, the transfer for value rule would not apply, because of the applicability of the transferor's basis exception (that is, Sheldon's basis is determined in whole or in part by reference to Bill's basis).

It should be noted that in a part-gift, part-sale situation in which the amount of consideration received by the transferor exceeds the transferor's basis (even though it is less than the market value of the policy), the carryover basis rule is not applicable, and the transferee's basis is the amount of consideration furnished (that is, the amount paid). In such a situation the transfer for value rule exception would not operate, and the rule would apply. In the example above, if Sheldon had paid $11,000 for the policy, that would be his basis, and the transfer for value rule would apply (that is, Sheldon's basis would not be determined in whole or in part by reference to Bill's basis but instead by reference to his cost of acquiring the policy).

Policy Transfers in Tax-Free Reorganizations

Under a number of circumstances involving the transfer of property to a corporation in connection with its formation or reorganization (for example, in a merger transaction), the transfer will not be considered a taxable transaction. In such circumstances, the property will take a carryover basis in the hands of the transferee. Thus, if a life insurance policy is transferred to a corporation in such a tax-free transaction, its basis in the hands of the transferee will be determined by reference to the basis in the hands of the transferor, and thus the transfer for value rule will not apply.

Policy Transfers Between Spouses or Incident to Divorce

Generally, the transfer for value rule does not apply to the transfer of life insurance policies between spouses as long as the transfer occurred after July 18, 1984, or, in the case of transfers after December 31, 1983, and on or before July 18, 1984, both spouses elect to have the nonrecognition rules of IRC § 1041 apply. The transferee's basis in the policy is equal to the transferor's adjusted basis immediately before the transfer, regardless of whether or not any consideration was paid, and thus the transfer falls within the "transferor's basis exception" to the transfer for value rule.

The transfer for value rule also will not apply in the case of life insurance policies transferred between spouses (or former spouses) under a divorce decree, as long as the divorce decree is entered into after July 18, 1984, or, in the case of decrees after December 31, 1983, and on or before July 18, 1984, the election is made to have the IRC § 1041 nonrecognition rules apply.

Transfer for Value Taint Cannot Be Removed by Subsequent Transfer That Would Otherwise Qualify for the Transferor's Basis Exception

If a policy has been the subject of a transfer for value transaction, and neither of the exceptions to the transfer for value rule is applicable, the death benefit will be subject to taxation as ordinary income. With limited exceptions (discussed below), once this "taint" attaches to a transferred policy it cannot be eliminated by a subsequent transfer to another party, even if the subsequent transfer is totally gratuitous and involves no valuable consideration. Just as the basis in the hands of the transferor will carry over to the transferee, so will the "taint" in effect carry over. See Treas. Reg. §§ 1.101-1(b)(2) and 1.101-1(b)(3)(iii) (providing that in the case of a transfer involving a carryover basis, the amount of death benefit that

can be excluded from income by the transferee may not exceed the amount that could have been excluded by the transferor if there had been no transfer (plus consideration and other amounts paid by the transferee)).

Example

Able acquires a $600,000 policy on his own life. After having paid premiums totaling $3,000, he sells the policy to Baker for $3,500, a transfer for value. Baker then makes premium payments totaling $4,000 more and transfers the policy for no consideration, as a gift to his daughter, Casey. Thereafter, Casey makes premium payments totaling $8,000. Able then dies, and Casey receives the death benefit of $600,000. Because of the prior transfer for value from Able to Baker, the death benefit is not exempt from taxation, even though no consideration was involved in the transfer by which Casey obtained the policy. Casey may, however, exclude from income the amount which Baker could have excluded ($3,500 purchase price, plus $4,000 in premium payments), plus the $8,000 which Casey paid in premiums, or a total exclusion of $15,500. Accordingly, Casey realizes ordinary income of $584,500.

Transfers of Business Life Insurance Under the Proper Party Exception—IRC § 101(a)(2)(B)

This exception to the transfer for value rule operates when the transferee is either the insured party or any of the following affiliates of the insured:

- a partner of the insured,
- a partnership in which the insured is a partner, or
- a corporation in which the insured is either an officer or a stockholder.

As long as the transferee is one of these so-called "proper parties," it does not matter whether or not the transfer involved any consideration flowing to the transferor. Moreover, if the final transferee of a policy is one of these proper parties, any transfer for value taint that may have attached to the policy as a result of any prior transfer for value will be eliminated and the death benefit will be receivable tax free. See Treas. Reg. § 1.101-1(b)(3)(ii).

Transfers to Grantor Trusts

Although not specifically dealt with in the proper party statutory exceptions in IRC § 101(a)(2), some types of transfers for consideration can, under certain circumstances, avoid the transfer for value rule, when there is effectively no change in the beneficial ownership of the policy for income tax purposes.

Rev. Rul. 2007-13

Rev. Rul. 2007-13, 2007-1 C.B. 684, reaches a favorable conclusion on the tax consequences of a transfer of a life insurance policy insuring the trust grantor's life, from one grantor trust to another, and from a nongrantor trust to a grantor trust. In both situations, the ruling concludes that the transferred policies will not be tainted by the transfer for value rule. IRS Rev. Rul. 2007-13 affirms the similar results obtained on IRS PLRs 200636086, 200606027, 200518061, 200514002, and 200514001.

The revenue ruling describes two situations:

Situation 1: Trust 1 and Trust 2 are grantor trusts, both of which are treated as wholly owned by Grantor. Trust 2 owns a life insurance contract on the life of Grantor. Trust 2 transfers the life insurance contract to Trust 1 in exchange for cash. In Situation 1, because Grantor is treated as the owner of both Trust 1 and Trust 2 for federal income tax purposes, Grantor is treated as the owner of all the assets of both trusts, including both the life insurance contract and the cash received for it, both before and after the exchange. Accordingly, in Situation 1 there has been no transfer of the contract within the meaning of the transfer for value rule (IRC § 101(a)(2)). In other words, an individual who owns two grantor trusts, one of which holds life insurance on his life, can move the insurance from one trust to the other without worry that the policy will run afoul of the transfer for value rule.

Situation 2: The facts are the same as in Situation 1, except that Trust 2 is not a grantor trust. In Situation 2, because Grantor is treated as the owner of all the assets of Trust 1 but not of Trust 2 for federal income tax purposes, Grantor is treated as the owner of the cash (but not the life insurance contract) before the exchange, and as the owner of the life insurance contract (but not the cash) after the exchange. Accordingly, in Situation 2 there has been a transfer of the life insurance contract for a valuable consideration within the meaning of the transfer for value rule (IRC § 101(a)(2)). Nevertheless, the taint of the transfer for value rule is avoided, because the transfer to Trust 1 is treated as a transfer to Grantor, the insured, within the meaning of the IRC § 101(a)(2)(B) proper party exception.

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In *Swanson v. Commissioner,* 33 T.C.M. (CCH) 296 (1974), the Tax Court held that when a grantor retained extensive powers to deal with the trust property, including the right to interpret or amend the trust instruments, he should be treated as the owner of the property. The only limitation on his power was the provision that he could not become the owner of the property. He could, however, add or change beneficiaries, alter trust provisions, and otherwise acquire complete control over the property. According to the court, there was no transfer for value to the extent of the grantor-insured's ownership of the trust corpus, in this case 91%. The remaining 9% of the insurance proceeds was subject to income tax under the transfer for value rule. ■