



# WRMarketplace

An AALU Washington Report

Thursday, April 2 2015

WRM# 15-12

The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

---

## **TOPIC: The Transfer for Value Rule – A Primer.**

**MARKET TREND:** Estate and business succession planning often involves life insurance, including transfers of existing policies to irrevocable life insurance trusts (“ILITs”) or other parties. Understanding the transfer for value rule and its potential tax impact is critical when considering such policy transfers.

**SYNOPSIS:** Death benefits paid under a life insurance policy generally are received by the beneficiary without imposition of income taxes. A transfer of the policy for “value,” however, will subject the policy death benefits to income tax pursuant to the “transfer for value” rule, to the extent the benefits exceed the consideration and subsequent premiums paid for the policy. Not all policy transfers for value are obvious, which may result in inadvertent application of the rule, although numerous exceptions exist.

**TAKE AWAYS:** A life insurance policy transfer can trigger the transfer for value rule, costing the beneficiaries dearly. Before any such transfer is made, a careful review of the facts, the transfer for value rule, and its exceptions should be considered.

**PRIOR REPORTS:** *13-48; 12-47; 11-105; 08-54; 07-23; 94-37.*

**MAJOR REFERENCES:** [Internal Revenue Code \(“Code”\) § 101\(a\)](#); [Treas. Regs. § 1.101-1](#); [PLR 201426005](#); [PLR 201423009](#).

With proper planning, the death benefits paid under a life insurance policy are not typically subject to income, estate and generation-skipping transfer taxes when they pass to the named beneficiaries. Great weight and discussion often are given to planning and potential estate tax implications regarding life insurance death benefit proceeds. Equally important but less frequently analyzed, however, are income tax implications and potential traps under the so-called “transfer for value rule” (“**TFV rule**”) that can be triggered when a policy is transferred – traps that can cause part or all of the insurance death benefits to be subject to income tax.

## ***THE TFV RULE***

**Application.** Generally, proceeds paid under a life insurance policy by reason of the insured's death are received by the beneficiary without imposition of income taxes.<sup>1</sup> An important and complex exception to this general tenet arises when the policy is transferred, by assignment or otherwise, for valuable consideration. If the TFV rule is triggered, the beneficiary will be subject to income tax on the portion of the death benefit that exceeds (i) the consideration paid for the policy, plus (ii) any subsequent premium payments and other amounts paid to maintain the policy.<sup>2</sup>

*Example:* Individual, A, purchases a life insurance policy insuring his life with a face value of \$1 million and annual premiums of \$2,500. After several years and the payment of \$10,000 in premiums, A sells the contract to his sister, B, for \$15,000. B pays an additional \$10,000 in premiums prior to A's death. The TFV rule applies – on A's death, B may exclude \$25,000 of the death benefit from income, but must report \$975,000 as taxable income. If the beneficiary is in the top income tax rate of 39.6%, the beneficiary could incur over \$386,000 in income taxes.

**Exceptions.** Several transfers for consideration, however, are excluded from application of the TFV rule. Exceptions exist for the transfer of a policy to:

- A person whose basis in the contract is determined in whole or in part by reference to the basis in the hands of the transferor (the so-called “**carry-over basis exception**”);
- The insured;
- A partner of the insured;
- A partnership in which the insured is a partner; or
- A corporation in which the insured is a shareholder or an officer.

The sale or transfer of a policy to address changed circumstances, such as from one trust to another with more preferable terms (where decanting is not available), or the transfer of a policy for business succession planning purposes, may run afoul of the TFV rule without careful consideration and planning.

## ***WHAT CONSTITUTES A TRANSFER FOR VALUABLE CONSIDERATION***

For the TFV rule to apply, both elements of the rule are required – (i) there must be a transfer (by assignment or otherwise), and (ii) there must be valuable consideration for the transfer (the requirement that the transfer be for consideration generally excludes gifts from the TFV rule). The Code and Treasury Regulations offer little guidance as to what constitutes a transfer for consideration. The Treasury Regulations indicate that a transfer for valuable consideration includes any absolute transfer for value of a right to receive all or part of the insurance proceeds. The creation of an enforceable contractual right to receive all or a portion of the policy proceeds, including a quid pro quo arrangement, may be sufficient to constitute a transfer for valuable consideration.<sup>3</sup> Neither a formal transfer of the policy nor tangible consideration is required.

*Example:* A, the owner and insured under a life insurance policy, agrees to name B as the beneficiary of the policy if B agrees to care for A during her advancing age. Upon A's death, the policy proceeds paid to B, as the designated beneficiary, could constitute taxable income if an enforceable contract was created.

Designating B as the beneficiary of the policy in return for services to be provided by B is sufficient to trigger the TFV rule, even though ownership of the policy did not change - the quid pro quo arrangement creates an enforceable contract giving B the right to receive the insurance proceeds upon A's death. Note, however, that pledging or assigning a policy as collateral security is specifically excluded under the Treasury Regulations as a transfer for valuable consideration.<sup>4</sup>

### ***SAFE HARBOR EXCEPTIONS TO THE TFV RULE***

***Carry-Over Basis Exception.*** The TFV rule does not apply if the transferee's basis in the policy is determined in whole or in part by reference to the transferor's basis in the policy. In such cases, the proceeds will be excluded from the transferee's gross income even if consideration was paid for the policy.

Transfers to the policy owner's spouse are included under this exception. Such transfers, even for consideration, generally fit within this safe harbor because the basis rules<sup>5</sup> treat transfers between spouses as nontaxable events - the basis of property in the hands of the transferee spouse is the same as in the hands of the transferor spouse.

*Example:* H owns a policy insuring his life which he sells to W, his wife, for an amount equal to the then value of the policy. W has a carry-over basis even though she paid consideration for the policy. Because W's basis in the policy is determined with reference to H's basis, upon H's death the policy proceeds will be excluded from W's gross income.

The carry-over basis exception also applies to transactions that are part gift and part sale. In a gift situation, the donee's basis in the policy is determined by reference to the basis in the hands of the donor. Accordingly, even a small gift element can result in excluding the entire proceeds from income tax in the donee's hands.

*Example:* A is the owner of a policy insuring his life with a \$750,000 death benefit. The policy has a current cash value of \$30,000 and A's basis in the policy is \$25,000. A sells the policy to his son, B, for \$15,000. A has made a gift to B of the difference between the fair market value of the policy (the cash value of \$30,000) and the price B paid for the policy. Because the transfer is part sale and part gift, the basis of the policy in B's hands is determined in part by reference to A's basis. Accordingly, even though there was a transfer for consideration, the carry-over basis exception applies and, upon A's death, the entire proceeds from the policy pass to the policy beneficiary without imposition of income taxes.

When planning, accurate valuation of the policy will be key to avoid running afoul of the TFV rule in a part gift, part sale transaction. An inaccurate value could result in eliminating the gift component, making the policy proceeds paid at the death of the insured taxable for income tax purposes.

***Transfers to the Insured.*** The transfer of a life insurance policy to the insured for valuable consideration is another important exception to the TFV rule and encompasses not just transfers directly to the insured but also transfers to and between trusts treated as wholly-owned grantor trusts for income tax purposes, including:

- The sale of a policy by the insured to his or her wholly-owned grantor ILIT. In such a sale, the grantor is treated as owning all assets of the ILIT. Accordingly, the insured should be considered to own the policy both before and after the transaction, as if no transfer was made. Further, the transfer by the insured to his grantor ILIT also should be a transfer to the insured and excepted from the TFV rule.<sup>6</sup>
- The sale of a policy between two wholly-owned grantor trusts of the same grantor. The transfer of a life insurance policy between two such grantor trusts should not be a transfer for value, even if the policy insures someone other than the grantor, because the grantor is treated as owning the policy both before and after the transaction.<sup>7</sup>
- The sale of a policy from a non-grantor trust to the insured's wholly-owned grantor trust. This transfer effectively constitutes a transfer of the policy to the insured and therefore should be excepted from the TFV rule.<sup>8</sup>

The exception for policy transfers to the insured, and the inclusion of transfers to wholly-owned grantor trusts in the exception, provides opportunities to adapt to major and unexpected changes in family circumstances or needs where insurance policies are held in ILITs.

***PLRs 201426005 and 201423009.*** The exceptions for transfers to the insured and transfers with a carry-over basis are illustrated in two recent Private Letters Rulings. In *PLR 201426005* and *PLR 201423009*, the IRS addressed the issue of the transfer of survivorship life insurance policies between grantor trusts, continuing and expanding the trend of excluding such transfers from the TFV rule. In the substantially similar PLRs, H and W, husband and wife, had created a grantor trust (the “**H&W Trust**”) treated as owned by both H and W for income tax purposes. The H&W Trust owned survivorship policies on H and W and a single life policy insuring W. H also had created a second trust (the “**H Trust**”), which was a grantor trust with respect to H for income tax purposes. It was proposed that the H Trust, which held substantial other assets, purchase all policies from the H&W Trust in order to ensure funding for the policy premiums.

First, the IRS analyzed the transfer from H's perspective. Because both trusts were grantor trusts with respect to H, there was no sale or exchange with respect to H's interest in the policies because H was treated as owning the policies both before and after the transaction. ***Thus, since the TFV rule applies only if there is a “transfer,” and H owned the policies both before and after the transaction, there was no transfer (for value or otherwise) from H to another party.***

Next, as W's interests in the policies also were being sold to the H Trust, the IRS analyzed the proposed transaction from W's perspective. The IRS noted that W was a grantor and a deemed owner of part of the H&W Trust, and that her husband, H was the deemed owner of the H Trust (although W was not). The IRS also noted the carry-over basis exception to the TFV rule for transfers where the basis of the life insurance contract in the hands of the transferee is determined in whole or in part by reference to the basis of such insurance contract in the hands of the transferor. That exception comes into play with regard to transfers between spouse through the interaction of the basis rules, which provide that no gain or loss is recognized on the transfer of property from an individual to such individual's spouse.<sup>9</sup> Because the H Trust was a grantor trust for federal income tax purposes and H would be treated as owning the policies for federal income tax purposes, the transfer would be treated effectively as a transfer from W to H. The H Trust would receive a carryover basis in the insurance policies under Code § 1041(b).

***Thus, the carry-over basis exception to the TFV rule would apply to the sale of W's interest in the life insurance policies from the H&W Trust to the H Trust, excluding that sale from application of the TFV rule.***

The PLRs offer helpful (albeit non-binding) guidance on how to implement trust-to-trust policy transfers, increasing the flexibility of ILIT planning without risking income or estate tax exposure.

***Transfers to a Partner of the Insured.*** The transfer of a life insurance policy to a partner of the insured for consideration also is exempt from the TFV rule.<sup>10</sup>

*Example:* F and his non-grantor trust are partners in a family limited partnership which holds commercial real estate. F owns 19% of the limited partnership interests, and the trust holds a 1% interest as a limited partner. F also owns a \$5 million policy insuring his life, for which he has paid \$100,000 in policy premiums. F sells the policy to the non-grantor trust for \$100,000 so that the trust can purchase assets from F's estate following F's death. Since the non-grantor trust is a partner of the insured, the transfer of the policy is exempt from the TFV rule, even though consideration was paid for the transfer.

***Transfers to a Partnership in Which the Insured is a Partner.*** Similarly, the transfer for consideration of a life insurance policy to a partnership (or a limited liability company taxed as a partnership) in which the insured is a partner is also exempt from the TFV rule. In the above example, if F instead sold his policy to the partnership so that the partnership could acquire his interest following his death, the purchase by the partnership would be excluded from the TFV rule.

Where a policy is sold to a partnership in which the insured is a partner or to the insured's partner, however, care should be taken to ensure the partnership has a legitimate business purpose. It is unclear whether the exception will apply if the partnership is deemed to be created solely for purposes of facilitating the sale of the policy. Although the IRS previously approved a transfer of policies to a partnership formed to "engage in the purchase and acquisition of life insurance policies on the lives of the partners",<sup>11</sup> this issue has long been included in the IRS's no-ruling list.<sup>12</sup> The IRS may scrutinize a partnership if it is deemed to have been created solely

for purposes of avoiding the TFV rule, particularly if the partnership is created close in time to its purchase of an existing life insurance policy and has no other business purpose.

***Transfers to a Corporation in Which the Insured is a Shareholder or Officer.*** Life insurance products are frequently used to cover key employees or as part of stock redemption agreements and shareholder cross-purchase agreements. The transfer of a life insurance policy for consideration to a corporation in which the insured is a shareholder or an officer is excluded from the TFV rule.

*Example:* H, a shareholder of Newco, Inc., individually owns a \$5 million policy insuring his life. H sells the policy to Newco, Inc. as part of a plan to fund a stock redemption agreement. The TFV rule does not apply since H is a shareholder of the company.

Unlike partners, transfers between shareholders of a corporation are not excluded from the TFV rule. In the above example if H instead sold the policy to another shareholder as part of a cross-purchase agreement, the transfer would be subject to the TFV rule.

### ***THE LAST TRANSFER RULE***

Once the taint of the TFV rule attaches to a policy, all subsequent transfers are also tainted unless the final transfer for value is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.<sup>13</sup>

*Example:* A owns a policy insuring her life, which she sells to her niece, N, for an amount equal to the value of the policy at the time of the transfer. N then gives the policy to her daughter, D, for no consideration. Upon A's death, D will be taxed on the proceeds to the extent the death benefit exceeds the amount N paid for the policy plus any premium payments paid by N and D. If prior to A's death, however, D sells the policy to her brother, B, who is a partner of A (B and A both own an interest in the same partnership), then the exclusion for transfers to a partner of the insured would apply and the taint would be removed, allowing the entire proceeds to pass to the policy beneficiary, without imposition of income taxes.

### ***POLICY LOANS***

When transferring an existing policy with substantial cash value to another party or to an ILIT, the insured/policy owner often considers drawing down the cash value by taking out a loan from the policy in order to reduce the amount of the gift. However, loans against the policy have the potential for triggering the TFV rule. If, as part of the transfer to the other party or the ILIT, the transferor is released from liability on the loan, the transferor will be deemed to have received valuable consideration, even if the transfer is intended as a gift and the transferor receives no other consideration for the policy. If the loan is less than the transferor's basis in the policy, then the carry-over basis exception to the TFV rule should apply since the transferee's basis will be determined in part by reference to the transferor's basis. On the other hand, if the loan exceeds the transferor's basis, the carry-over basis exception will not apply and the transfer will be

subject to the TFV rule unless another exception applies (i.e., the transfer is to the transferor's spouse, to the insured's wholly-owned grantor trust, the insured's partner, etc.).

### **TAKE-AWAYS**

- A life insurance policy transfer can trigger the TFV rule, costing the beneficiaries dearly.
- Before any such transfer is made, a careful review of the facts, the TFV rule, and its exceptions should be considered.

### **NOTES**

---

<sup>1</sup> Code § 101(a)(1).

<sup>2</sup> Code § 101(a)(2).

<sup>3</sup> Treas. Regs. § 1.101-1(b)(4).

<sup>4</sup> *Id.*

<sup>5</sup> *See*, Code § 1041.

<sup>6</sup> *See*, Rev. Rul. 85-13, 1985-7 I.R.B. 28.

<sup>7</sup> Rev. Rul. 2007-13, Situation 1.

<sup>8</sup> Rev. Rul. 2007-13, Situation 2.

<sup>9</sup> Code § 1041(a)(1).

<sup>10</sup> *See e.g.*, PLR 9045004 (IRS approved the transfer of a life insurance policy to a partner of the insured who owned only a 1% interest in the partnership).

<sup>11</sup> PLR 9309021. The IRS approved the transfer by a corporation that owned policies insuring the lives of its two shareholders to a partnership formed by the shareholders with the purpose of acquiring the policies.

<sup>12</sup> Rev. Proc. 2014-3, § 3.01(12).

<sup>13</sup> Treas. Regs. § 1.101-1(b)(3)(ii).

### **DISCLAIMER**

**This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.**

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the *Essential Wisdom Series*, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

### **WRM #15-12 was written by Greenberg Traurig, LLP**

Jonathan M. Forster

Martin Kalb

Richard A. Sirus

Steven B. Lapidus

Rebecca Manicone

### ***Counsel Emeritus***

Gerald H. Sherman 1932-2012

Stuart Lewis 1945-2012