Life Insurance Planning

The transfer-for-value rule: An often-overlooked life insurance tax trap.

By Eva Stark, JD, LL.M.

Estate planning, whether simple or complex, often incorporates life insurance. Life insurance death benefits can help support a deceased individual's family, pay off debt, provide funds to equalize inheritances where the bulk of the estate is tied up in a closely held business, create liquidity for the payment of estate taxes, and help achieve numerous other planning objectives. In addition to helping resolve many estate planning challenges, life insurance also may offer tax benefits.

Tax-free death benefit

One notable tax benefit of life insurance is that death proceeds are generally received by a beneficiary free of any income taxation. Public policy has favored this treatment as life insurance is regularly relied upon by families to support children and surviving spouses where a primary income earner dies prematurely.

The transfer-for-value rule

In contrast, those transferring life insurance contracts for profit are not considered as sympathetically, and Congress sought to limit speculators' ability to take advantage of tax-free treatment. The "transfer-for-value" rule was created to limit income tax benefits with respect to any policy that is sold or transferred for valuable consideration. Under the rule, the amount of a death benefit that may be excluded from gross income is limited to the value of the consideration paid plus any premiums and other amounts subsequently paid by the transferee (i.e., by the buyer or recipient of the policy). Any death benefit above such amount is generally taxable as ordinary income.

The "trap" in this rule is that ordinary individuals who may transfer policies for estate or business planning purposes may not recognize that consideration is being provided for a policy that is transferred. Consideration obviously encompasses money paid in exchange for a policy, but it also may include non-cash benefits, whether tangible or intangible, or even a mutual agreement or promise.

For example, suppose that each of the two co-shareholders in a corporation owns a policy on his own life. After executing a cross-purchase buy-sell agreement, the shareholders decide to exchange with each other their existing policies to fund the agreement and forego purchasing new policies (perhaps an owner may not be insurable). Shareholder A transfers the policy on his own life to shareholder B and vice versa. Following the transfer, shareholder A owns a policy on the life of shareholder B, and as the new owner, names himself beneficiary. At shareholder B's death he will collect a death benefit and use it to buy shareholder B's interest from shareholder B's estate.

Because the policies were transferred in exchange for valuable consideration (i.e., for a life insurance policy and a mutual agreement to buy-sell), the rule has been triggered and a portion of the death benefit may now be subject to income tax at ordinary income rates.

Exceptions

Fortunately, the transfer-for-value rule offers five exceptions where death benefits remain income-tax free despite a transfer for valuable consideration. These exceptions include transfers:

1. To the insured under the contract;
2. To a partner of the insured;
3. To a partnership in which the insured is a partner;
4. To a corporation in which the insured is a shareholder or officer (note that there is not a transfer to a co-shareholder exception); and
5. Where the transferee's basis in the policy is determined in whole or in part by the transferor's basis.

Even if a policy is "tainted" because it has been transferred for valuable consideration where no exception applied, it may be possible in certain circumstances to "remove" such taint by subsequently transferring the policy in a manner that an exception does apply.

Applying the transfer-for-value rule and its exceptions is complicated, and individuals should explore with a qualified attorney or certified public accountant how the rule or any of its exceptions may apply in their particular circumstances.

Conclusion

Whenever a policy is transferred, planners, tax advisors and policyholders should be vigilant to ensure that no consideration exists, or if consideration may exist, that the transfer falls within one of the five exceptions to the transfer-for-value rule. Such precautions may help avoid unexpected tax outcomes and help ensure that the policy's death benefit may remain income-tax free.

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