

## BUSINESS CONCEPTS

# Transfers for Value

## The Situation...

- With few exceptions, the death proceeds of a life insurance policy, paid to beneficiaries, are exempt from federal income tax.
- One important exception occurs when a policyowner sells or transfers a policy for a valuable consideration.
- When a transfer occurs, the income tax exemption for the death proceeds is limited to the purchase price plus any subsequent premiums paid by the policyowner.
- The portion of the death proceeds includible in the beneficiary's gross income is equal to the death proceeds payable minus the purchase price and subsequent premiums paid by the policyowner.

## Exempt Transfers...

When a policyowner makes a gift by transferring a policy without receiving valuable consideration, the death proceeds still qualify for a full income tax exemption. If the gifted policy has a loan against it that exceeds the donor's basis, this becomes a transfer for value. Certain "exempt transferees" can purchase a policy without triggering a transfer for value. Exempt transferees include:

- The insured
- The insured's spouse (if the policy is purchased directly from the insured)
- A partner of the insured
- A partnership in which the insured is a partner
- A corporation in which the insured is an officer or shareholder
- A person who receives the policy by any form of transfer in which the transferee's tax basis in the policy is determined by reference to the transferor's basis

## Non-exempt Transfers...

If a non-exempt transferee purchases an existing life insurance policy, the death proceeds are partially subject to federal income tax. Some common non-exempt transferees include:

- A co-shareholder of the insured
- A child or sibling of the insured (unless the transfer is by gift)

- The insured's irrevocable trust (unless the irrevocable trust is a grantor trust)
- The insured's key employee

### Other Transfers...

- While a purchase by the insured's spouse from the insured is an exempt transfer, the spouse's purchase from any other party, such as the insured's employer or business partner, is not an exempt transfer.
- A purchase by the insured's revocable living trust—when the insured is treated as the owner of the trust for tax purposes—is treated as a transfer to the insured, who is an exempt transferee.

### Reportable Policy Sales

- Every transfer for value must be evaluated to determine if it constitutes a “reportable policy sale”—an acquisition of an interest in a life insurance contract, directly or indirectly, where the acquirer has no substantial family, business, or financial relationship with the insured.
- If the transfer is found to be a reportable policy sale, the death benefit will be taxable.
- When a death benefit is paid out under a contract that is found to be a reportable policy sale, the buyer must provide information about the purchase to the IRS, the issuing insurance company, and the seller.

### The Bottom Line...

Since transferring ownership of a life insurance policy can raise questions concerning the income tax status of the policy's death benefit, it is important to identify the transferee and determine under what circumstances the policyowner will make the transfer.

### SUMMARY

#### What Is a “Transfer for Value”?

Under Section 101 of the Internal Revenue Code, most life insurance death benefits are received free of federal income tax. But, if a policy has been sold or otherwise transferred for valuable consideration, the portion of the death benefit that exceeds the policy’s cost basis may be taxable as ordinary income.

A “transfer for value” occurs when an owner transfers a life insurance policy in exchange for something of value, unless the transfer falls into an exempt class. However, an actual sale isn’t necessary, because even a promise or agreement providing for a right to receive the policy proceeds in exchange for value can result in a transfer for value.

#### What Are Some Examples?

The most common transfer-for-value problems arise in business insurance situations involving key employee or buy-sell policies. Also, special rules apply when pensions are involved.

The simplest example of a transfer for value is the sale of the policy for its cash value to a transferee who is not exempt. However, if a policy is transferred without any cash changing hands and the policy is subject to a loan that exceeds its cost basis, a transfer for value has occurred.

If the policyowner agrees to name a third party as beneficiary of all or part of the death proceeds for valuable consideration, a transfer for value occurs even though no actual assignment of the policy has taken place.

#### Which Transfers Are Exempt?

Certain categories of transferees can purchase a life insurance policy without triggering a transfer for value. These exempt transferees are:

1. The insured
2. The spouse of the insured individual (if the policy is purchased directly from the insured)
3. A partner of the insured
4. A partnership in which the insured is a partner
5. A corporation in which the insured is a shareholder or an officer

Also, a gift of a policy is generally not a transfer for value, since it is considered a gratuitous transfer motivated by detached and disinterested generosity. If the death proceeds would have been exempt to the gift donor, they will be exempt to the donee. However, if the gifted policy has a loan against it that exceeds the donor’s basis, this creates a transfer for value.

If the policyowner exchanges anything of value for the policy, a transfer for value will occur unless the transferee is in one of the exempt categories.

#### Are Life Insurance Death Benefits Taxable in Other Situations?

Life insurance death benefits may also be taxable if:

- Proceeds include the cash value portion of a policy held in a qualified retirement plan
- Proceeds are received through a corporation as compensation or dividends
- Proceeds are received by a creditor on the life of a debtor

- There was no insurable interest in the life of the insured
- In some cases, if an employer did not obtain written consent from an employee after providing notice of an intent to insure the employee
- Proceeds are received as part of a “reportable policy sale”

### How Can Policyowners Avoid Problems with Transfers?

Since transferring ownership of a life insurance policy can raise questions concerning the income tax status of the policy's death benefit, it's important to take care when identifying the transferee and determining under what circumstances the transfer is to be made.

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