CHAPTER 62

Transfer for Value Rule

CHRIS SOTO (Tempe, Arizona)

Life insurance is an important estate and financial planning tool. Life insurance is an extremely efficient way to meet cash and liquidity needs that arise when someone dies. One of the most attractive aspects of life insurance as an estate planning tool is the tax treatment of the proceeds. As a general rule, proceeds a beneficiary of a life insurance policy receives when the insured dies are entirely income tax free. However, an easily missed tax trap known as the "transfer for value rule" can cause some or all of your life insurance policy proceeds to become income taxable. In order to ensure life insurance proceeds will be fully available to your beneficiaries, it is critical that you avoid triggering the transfer for value rule.

As the name implies, the transfer for value rule is triggered when there has been a transfer of a life insurance policy (or an interest in the policy) and valuable consideration is given in exchange for that transfer. Transfer for value rule issues often arise in connection with buy-sell agreements where business owners are using life insurance proceeds to buy out a co-owner's interest on the death of the co-owner. Consider the following example: Andrew and John are the shareholders of their closely-held corporation. Andrew buys a $1 million policy on John's life. When John dies, Andrew collects the life insurance proceeds and intends to use those proceeds to buy out John's ownership in the corporation. If Andrew bought the life insurance policy from John, the proceeds will be subject to ordinary income tax, which could result in an income tax bill of over $300,000, leaving a fraction of the proceeds available to buy out John's shares. However, if instead of buying a policy transferred from John, Andrew purchased $1 million in insurance on John's life directly from the insurance company, the $1 million in life insurance proceeds would go to Andrew completely income tax free and leave the full $1 million available to fund the buyout of John's shares.

It is also important to understand the transfer for value rule can arise any time economic benefits of a life insurance policy are transferred in return for valuable consideration — even if there is no transfer of ownership of the policy. As an example, if Steve makes his friend, Jim, the beneficiary of a policy on Steve's life in exchange for Jim's transfer of ownership of his houseboat, there has been a transfer for value. Therefore, if there is a transfer — even of a mere interest in a policy —

and that transfer is made in exchange for any type of economic consideration, the transfer for value tax trap is set.

Fortunately, the tax laws contains several exceptions to the transfer for value rule. A beneficiary can continue to receive insurance proceeds income tax free, even if there has been a transfer for value, in each of the five following circumstances:

1. A transfer to the insured;
2. A transfer to a partner of the insured;
3. A transfer to a partnership in which the insured is a partner;
4. A transfer to a corporation in which the insured is a shareholder or officer; and
5. The transferor's basis exception.

Following are some examples of transfers which fall within the exceptions outlined above:

- If a corporation owns a life insurance policy on the life of a key executive, Jim, and the corporation transfers the policy to Jim for valuable consideration, the life insurance proceeds will remain income tax free when Jim dies, because Jim was the insured and the transfer falls within the transfer to the insured exception.
- Joe and Al are partners in a partnership. Joe sells Al a policy on Joe's life in exchange for a cash payment. Because it is a transfer to a partner of the insured, this transfer is an exception to the transfer for value rule, and Al's receipt of the policy proceeds will be income tax free.[1]
- Similarly, if Al sold a policy on his life to the partnership in exchange for financial consideration, this falls within an exception and the partnership will receive the proceeds income tax free.

These exceptions to the transfer for value rule provide you and your advisors with a number of creative opportunities and tools to transfer interests in life insurance policies while keeping the life insurance death proceeds completely income tax exempt.

In summary, if the IRS determines you have made a transfer of an interest in a life insurance policy that triggers the transfer for value rule, it could have devastating income tax ramifications to the beneficiary, and could have a potentially catastrophic effect on the objectives for which the insurance was purchased. Therefore, it is critical you and your advisors carefully analyze any potential transfer of an interest in a life insurance policy to determine whether the transfer for value rule applies. Proper navigation of the transfer for value rule and proper coordination of policy ownership and beneficiary designations can literally allow you to leave an unlimited amount of life insurance proceeds to your beneficiaries completely estate and income tax free.

The Soto Law Firm is dedicated to providing comprehensive, highly personalized estate planning services to couples, families, individuals, and businesses.

1. It is important to note that this exception only applies to partners in a partnership, not to shareholders in a corporation. If instead of being partners, Joe and Al were shareholders in a corporation, this transfer would not fall within the transfer to a partner of the insured exception, and the life insurance proceeds would be income taxable upon Joe's death.