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Understanding Transfer for Value

What Is A Transfer For Value In Connection With Life Insurance?

The Advanced Markets Group is often asked questions about the federal income tax consequences of a transfer of a life insurance contract that may constitute a transfer for value under Internal Revenue Code Section 101(a). Transferring a life insurance policy is not as simple as just filing a change of ownership with the issuing carrier. A transfer of the life insurance policy for valuable consideration can change the income taxation of the policy's death benefit. Fortunately for owners of life insurance contracts, there are exceptions to the transfer for value rule provided by §101(a).

How are the death benefits paid on a life insurance contract generally taxed?

§101(a) of the IRC establishes the income taxation of the proceeds of life insurance received by the policy's beneficiary and payable by reason of the insured's death. The general rule, under §101(a)(1), is that the gross income of the policy's owner does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured. In other words, the general rule is that life insurance death benefits are received by the policy's beneficiaries income tax free.

What if I've transferred my policy?

A transfer of a life insurance contract in exchange for valuable consideration changes the general rule provided by §101(a)(1). §101(a)(2) of the IRC says that in situations where the life insurance contract, or the death benefit, has been transferred for a valuable consideration, by assignment or otherwise, the death benefit becomes subject to income taxes. The amount of the death benefit that is now income taxable is the excess of the death benefit over the amount actually paid for the contract plus any premiums and other amounts paid by the transferee following the

transfer. The phrase "other amounts" includes interest paid or accrued by the transferee on indebtedness with respect to such contract, or any interest therein if such interest paid or accrued is not allowable as a deduction under §264(a)(4).

What constitutes "valuable consideration"?

Certainly "valuable consideration" includes a transfer of the policy in exchange for money or money's worth, but it also extends to more than just money. Treas. Reg. §1.101-1(b)(4) states that a transfer for valuable consideration is "any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy." Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for valuable consideration of the policy or an interest therein. On the other hand, the pledging or assignment of a policy as collateral security is not a transfer for valuable consideration of such policy or an interest therein, and §101 is inapplicable to amounts received by the pledgee or assignee.

Are there any exceptions to the transfer for value rule?

Luckily, there are several exceptions to the transfer for value rule provided by §101(a)(2)(A) and (B). Specifically, the death benefit will not be subject to income taxes, even in the case of a transfer of the policy, or an interest in the policy, if the transfer is to:

- The insured;
- A partner of the insured;
- A partnership in which the insured is a partner;
- A corporation in which the insured is a shareholder; or
- If the transferee's basis in the transferred policy is determined in whole, or in part, by the transferor's basis in the contract.

Is it possible to “clear” a transfer for value “taint”?

In the case of a series of transfers, Treas. Reg. §1.101-1(b)(3) provides that, if the last transfer of the life insurance policy, or an interest therein, is for valuable consideration, the general rule is that the final transferee may only exclude from income the sum of the actual consideration paid by the final transferee plus premiums and other amounts actually paid by him. However, if the final transferee is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder, then the final transferee can exclude the entire death benefit from gross income.

This means that if there as been a transfer for value that would make the policy's proceeds subject to income taxation, this transfer for value “taint” can be cleared if the policy is transferred again and this last transfer falls within one of the exceptions to the transfer for value rule.

Are there any examples of how the transfer value rule and the exceptions work?

Example 1 A pays premiums of \$500 for an insurance policy in the face amount of \$1,000 upon the life of B, and subsequently transfers the policy to C for \$600. C receives the proceeds of \$1,000 upon the death of B. The amount which C can exclude from his gross income is limited to \$600 plus any premiums paid by C subsequent to the transfer.

Example 2 The X Corporation purchases, for a single premium of \$500, an insurance policy in the face amount of \$1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. The X Corporation transfers the policy to the Y Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Y Corporation determined by reference to its basis in the hands of the X Corporation). The Y Corporation receives the proceeds of \$1,000 upon the death of A. The entire \$1,000 is to be excluded from the gross income of the Y Corporation.

Example 3 The X Corporation purchases for a single premium of \$500 an insurance policy in the face amount of \$1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. Prior to the death of A, the X Corporation transfers the policy to the Z Corporation for \$600. If A were to die, the Z Corporation would receive the proceeds of \$1,000 would be able to exclude from its gross income \$600 plus any premiums paid by the Z Corporation subsequent to the transfer of the policy to it. However, prior to A's death, the Z Corporation transfers the policy to the N Corporation, in which A is a shareholder. The N Corporation receives the proceeds of \$1,000 upon the death of A. The entire \$1,000 is to be excluded from the gross income of the N Corporation.

Example 4 A pays premiums of \$500 for an insurance policy in the face amount of \$1,000 upon his own life, and subsequently transfers the policy to his wife B for \$600. B later transfers the policy without consideration to C, who is the son of A and B. C receives the proceeds of \$1,000 upon the death of A. The amount which C can exclude from his gross income is limited to \$600 plus any premiums paid by B and C subsequent to the transfer of the policy to B. Prior to the death of A, C transfers the policy without consideration to A, the insured. A's estate receives the proceeds of \$1,000 upon the death of A. The entire \$1,000 is to be excluded from the gross income of A's estate.

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