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GUIDEPOST

Transfer for Value Rule



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Though life insurance death benefit is generally received income tax-free, pursuant to Internal Revenue Code (IRC) §101(a)(2), if a life insurance policy or any interest in a life insurance policy is transferred for valuable consideration, the death benefit which will be excluded from gross income is limited to the value of the consideration paid for the life insurance policy plus any premiums paid by the transferee after the transfer. The balance will be taxable to the transferee as ordinary income. If the transfer falls within one of the exceptions to the transfer for value rule, however, the entire death benefit will remain income tax-free.

General rule

The transfer for value rule applies any time a policy is transferred for valuable consideration. A transfer for valuable consideration includes not only a sale of an interest in a policy for cash, but also transfers in exchange for any type of property or a contractual promise. In addition, naming a beneficiary of a policy in exchange for any kind of valuable consideration would be considered a transfer for value of an interest in the policy. Use of a separate contract to give the right to receive proceeds in exchange for money or other valuable consideration falls under the transfer for value rule. However, a pledge or assignment of a policy as security is not a transfer for value. If a policy is transferred for valuable consideration, a portion of the death benefit payable will be subject to income tax at ordinary income tax rates unless an exception applies.

Transfers by gift

The gift of a policy is generally not a transfer for value. If the tax-free status of death benefit has been lost due to a prior transfer for value, the subsequent gift of the policy will not negate the income taxation of the death benefit unless the gift is made to a party who qualifies under one of the exceptions.

Three-year rule

Generally, IRC §2035 provides that a transfer of a policy by an insured within three years of death will result in estate inclusion of all policy proceeds. However, under IRC §2035(d), the three-year inclusion rule does not apply to a bona fide sale for adequate and full consideration.

Transfer of policy subject to a loan

If a policy is gifted and subject to a loan greater than the donor's basis at the time of the gift, the donee is treated for income tax purposes as if he/she purchased the policy from the donor in exchange for the loan amount. Thus, the gift of the policy may be subject to the transfer for value rule. Further, the amount of the loan that exceeds basis could be treated as taxable income to the donor. If, however, the value of the policy exceeds the loan, the transfer would fall within an exception to the transfer for value rule as the basis in the hands of the transferee is determined in part by reference to the basis of the policy in the hands of the transferor.

Exceptions to general rule

There exist several exceptions to the transfer for value rule. These exceptions include a transfer for valuable consideration to:

- The insured, including a grantor trust established by the insured.
- A partner of the insured, partnership (including a limited liability company (LLC) taxed as a partnership) in which the insured is a partner, or corporation in which the insured is an officer or shareholder.
- A transferee where the basis for determining gain or loss in the hands of the transferee is determined in whole or in part by reference to the transferor.

If multiple transfers have occurred and a previous transfer of the policy violates the transfer for value rule but the final transfer falls within one of the exceptions, the death proceeds will not be income taxable.

Detailed explanation of exceptions

Transfer to the insured

A transfer for value of a policy to the insured is an exception to the transfer for value rule. A transfer to a trust that is treated as wholly owned for income tax purposes by the insured also falls within this exception (this would include a revocable trust as well as an irrevocable grantor trust).

Transfer to a partner of the insured or a partnership in which the insured is a partner

A transfer for value of a policy to an individual/entity who is a partner of the insured, or to a partnership in which the insured is a partner is an exception to the transfer for value rule. LLCs taxed as partnerships also fall under this exception. Accordingly, a transfer for value of a policy to a member of an LLC taxed as a partnership in which the insured is also an LLC member or a transfer to the LLC in which the insured is a member will not cause the death benefit under the policy to become income taxable.

A corporation in which the insured is an officer or shareholder

A transfer for value of a policy to a corporation in which the insured is a shareholder of the corporation or an officer of the corporation is an exception to the transfer for value rule. Note that the exception does not apply to transfers from a corporation to an officer or shareholder who is not the insured, nor among shareholders if the transferee is not the insured. In addition, the exception does not apply to transfers of a policy to a corporation if the insured is merely a non-officer employee.

Transfer between spouses

A transfer of a policy between spouses (includes ex-spouses if incident to divorce) or trusts for a spouse's benefit is generally treated as if the transferee acquired the policy by gift under IRC §1041. A transfer of property is considered "incident to divorce" if the transfer occurs within one year after termination of the marriage.

Furthermore, under IRC §1041(b), an actual sale of a life insurance policy by the insured to the insured's spouse keeps the purchasing spouse's basis the same as the insured's basis; therefore, even though the sale to a spouse is a transfer for value, it qualifies for the transferred basis exception. Note that a transfer to a spouse from other parties (such as insured's employer or business) is not an exempt transfer.

Basis for determining gain or loss in the hands of the transferee is determined in whole or in part by reference to the transferor

A transfer of a policy in which the party who receives the policy takes the same income tax basis in the policy as the transferor is an exception to the transfer for value rule.

Examples of the basis exception include:

- Acquiring a policy by gift – see previous explanation above.
- Transfer of a policy from one corporation to another in a tax-free reorganization will fall within this exception. However, if a corporation purchases a policy from another corporation and the transaction is not a tax-free reorganization, the transfer may cause loss of income tax-free status for the death benefit unless the insured is an officer or shareholder of the corporation acquiring the policy.

Common scenarios

Transfer of policy within a buy-sell arrangement for a corporation

- **Transfers of policies after death of a shareholder in a cross-purchase arrangement.** Surviving shareholders may wish to re-allocate policies upon the death of a shareholder. A transfer of a policy to a non-insured shareholder would

be considered a transfer for value and would not fall within an exception (unless the shareholders are also partners in a partnership or members of an LLC taxed as a partnership).

- **Re-structuring buy-sell arrangement from stock redemption to cross-purchase.** The transfer of a policy from a corporation to a non-insured shareholder will be a transfer for value and would not fall within an exception (unless the shareholders are also partners in a partnership or members of an LLC taxed as a partnership).
- **Re-structuring buy-sell arrangement from cross-purchase to stock redemption.** If shareholders transfer policies they own on other shareholders to the corporation, the transfer would fall within an exception to the transfer for value rule.

Transfer of policy within a buy-sell arrangement for an LLC or partnership

- **Re-structuring buy-sell arrangement from entity to cross-purchase.** If partners wish to re-structure a buy-sell arrangement from an entity arrangement to a cross-purchase, the transfer of policies to partners would fall within an exception to the transfer for value rule.
- **Re-structuring buy-sell arrangement from cross-purchase to entity.** If the partners wish to re-structure a buy-sell arrangement from a cross-purchase to an entity arrangement, the transfer of policies to the partnership would fall within an exception to the transfer for value rule.

Transfer of policy involving trusts

- A transfer for value of a policy from a grantor trust to a grantor trust (where the grantor is the same) will fall within an exception to the transfer for value rule as this transfer is treated as a transfer to the insured for income tax purposes.
- A transfer for value from a non-grantor trust to a grantor trust will also fall within an exception to the transfer for value rule as this transfer is treated as a transfer to the insured for income tax purposes.

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