



Transfer for Value Rule

Overview

The irrevocable life insurance trust (ILIT), when structured properly, is a staple of estate planning for high net worth families. An ILIT can provide a means to make leveraged transfers to heirs free of both estate and income tax. Ideally, the trust is drafted prior to application for and purchase of the life insurance policy that it will eventually hold as its primary asset. However, circumstances may arise which result in a need to transfer an *existing* policy into a trust. In this event, special measures must be taken to preserve the income and estate tax benefits of the ILIT.

Generally, Section 2035 of the Internal Revenue Code (Code) 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 Section 2035(d), the three-year inclusion rule does not apply to a bona fide sale for adequate and full consideration. A sale of a policy to a trust, however, gives rise to its own set of issues, namely policy valuation, trust funding, and the transfer for value rule under Section 101(a) of the Code.

General Rule and Exceptions

According to Internal Revenue Code Section 101(a)(2), if a policy or any interest in a 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 plus any premiums paid by the transferee after the transfer. The balance will be taxable as ordinary income. However, if the transfer falls within one of the following exceptions, the entire death benefit will remain income tax-free.

Exceptions to the Transfer for Value Rule; a Transfer for Valuable Consideration to:

- ◆ The insured. (Note: A grantor trust established by the insured falls within this exception.)
- ◆ A partner of the insured, partnership in which the insured is a partner, or corporation in which the insured is an officer or shareholder. (Note: Limited liability companies taxed as partnerships fall within this exception.)

- ◆ 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 Look at the General Rule

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.

Transfers by Gift

Transfer 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 listed above.

Transfer of Policy Subject to a Loan If a policy is gifted and subject to a loan in excess of the donor's basis at the time of the gift, the donee is treated for income tax purposes as if he purchased the policy from the donor for the amount of the loan. Thus, the gift of the policy may fall within the transfer for value rule. Further, the amount of the loan in excess of 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.

Explanation of Exceptions

Transfer to the Insured – A transfer for value of the policy to the insured will result in the death benefit remaining income tax free. 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 – LLCs taxed as partnerships also fall under this exception. Accordingly, a transfer for value of a policy to an LLC member 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 – 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.

If 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 – Examples include:

- ◆ Acquiring a policy by gift – see 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.
- ◆ 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 Section 1041. Transfer of property is considered "incident to divorce" if the transfer occurs within one year after termination of the marriage. Note that a transfer to a spouse from other parties (such as insured's employer or business) is not an exempt transfer.

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).
- ◆ 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).
- ◆ 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.

Note that while transfers between business entities and owners may fall within an exception to the transfer for value rule, preserving the income tax-free nature of the death benefit, income tax consequences may result upon the transfer. See the Transfer of Policy to or from Business Guidepost for additional information.

Transfer of Policy Involving Trusts

- ◆ A transfer for value of a policy from a grantor trust to a grantor trust 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 a transfer to the insured for income tax purposes.



Lloyd R. Wilson & Associates

Lloyd Wilson*, AEP®, CLU®

2311 Highland Avenue S., Suite 101, Birmingham, AL 35205
Phone: (205)933-2700
lrwilson@ft.newyorklife.com

*Registered Representative offering securities through NYLIFE Securities LLC, Member FINRA/SIPC, a Licensed Insurance Agency, (2311 Highland Avenue S., Suite 101, Birmingham, AL 35205). Financial Adviser offering investment advisory services through Eagle Strategies LLC, a Registered Investment Adviser. Member Agent of The Nautilus Group®, a service of New York Life Insurance Company. Lloyd R. Wilson & Associates is not owned or operated by New York Life Insurance Company or its affiliates.

This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. Lloyd R. Wilson & Associates as well as New York Life Insurance Company, its agents and employees may not give legal, tax or accounting advice. Please consult your own professional advisors before making any decisions.

This information was produced by New York Life Insurance Company and provided as a courtesy by Lloyd Wilson. © 2015 New York Life Insurance Company. All rights reserved. SMRU 526347 (exp. 1.31.2020)

Lloyd Wilson AR Insurance License Number 554591