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TRANSFERS FOR VALUE

Life Insurance Death Proceeds are **typically exempt** from **income taxation** under IRC Section 101(a)(1). The “gift” of a policy during the insured’s lifetime does not affect this exemption. However, **the “sale” of a policy** may subject part of the **proceeds** to **income taxation** when the insured dies. If a policy is “transferred for value” to a **non-exempt transferee**, the portion included as taxable income will be the face amount less any consideration (purchase price and subsequent premiums) paid by the transferee.

PARTIES WHO CAN PURCHASE A POLICY FROM ANOTHER AND ARE EXEMPT TRANSFEREES (NO EXCEPTIONS):

1. The insured
2. A partner of the insured
3. A partnership of which the insured is a partner
4. Corporation of which insured is a shareholder/officer
5. Any person where the basis is determined by reference to the transferor’s basis, e.g., a gift.

TYPICAL VIOLATIONS OF THIS RULE:

1. A policyowner **agrees to name another person** as a beneficiary in exchange for **valuable consideration**. Reg. Sec. 1.101-1(b)(1).
2. When **two persons** assign policies on their own lives to each other at about the **same time**, the question of a transfer for valuable consideration is raised.
3. A **corporation** changes its **buy-sell agreement** from a **stock redemption** plan to a cross purchase plan and transfers key person insurance policies to stockholders other than the insured.
4. For estate planning reasons, a **corporate key man life insurance policy** is transferred to the **insured’s adult child** or an **irrevocable trust** to keep the proceeds out of the estate. Since she (or he) is not an employee, the policy is usually purchased for its current cash value.

PROBLEM: The child or trustee is **not an exempt party** and under the “Transfer for Value” rule the proceeds may be out of the estate, but are **partially includable** as **ordinary income** in the year received by the beneficiary.

A BETTER WAY: Have the **insured purchase the policy** from the corporation (the insured is an exempt party). He is now free to **make a gift** of the policy to the child or trust. However, the donor/insured must survive the **3 year contemplation of death period**. IRC Sec. 2035.
Where there is a non-exempt party owning a purchased policy, it may be wise to have the insured purchase it back for its cash value and then, by a later gift, transfer it back to the non-exempt party. This will remove the “taint.” Reg. Sec. 1.101-1(b)(2)

When changing from a Corporate Stock Redemption Plan to a Cross Purchase Buy-Sell arrangement, consider a separate partnership. See Letter Rulings 9328010, 9328012, 9328017, 9328019 and