INRODUCTION

Life insurance is one of the cornerstones of estate planning. Life insurance creates instant cash to solve personal or business problems at the insured’s death. If the policy ownership and beneficiary designation are arranged properly, life insurance proceeds can be both estate and income tax-free.

Yet a small slip can cause either the estate or income tax (or both) to apply. If life insurance is subject to income tax, it is taxed at ordinary income tax rates rather than capital gains rates. In 2013, that income tax rate may be nearly 40 percent.

There are several methods by which policy owners may make life insurance death proceeds income taxable. In this issue we will focus on the transfer for value rule. This rule, if invoked, can cause the life insurance death benefit to be taxed as ordinary income, rather than income-tax free, to its intended beneficiary.

Eight years ago we discussed the transfer for value rule in an issue of Think About It. In 2012, the IRS issued Private Letter Ruling (PLR) 201235006, which discusses, in part, how that rule works. The PLR gives a favorable conclusion in a recurring estate planning situation. To give readers some context for understanding the PLR, revisiting the transfer for value rule is in order.

This issue will:

- review what the transfer for value rule is,
- explain the exceptions to the rule, and
- illustrate how it operates in typical, real-life situations.

Finally, we will discuss PLR 201235006 and the kinds of planning opportunities it encourages.

THE TRANSFER FOR VALUE RULE

General Rule

In general, the Tax Code says that all income is taxable. However, Code Section 101(a) provides that

> gross income does not include amounts received under a life insurance contract if those amounts are paid by reason of the insured’s death.
The tax-free nature of the life insurance death benefit is good news for life insurance professionals and policy beneficiaries. However, Code Section 101 goes on to say:

In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income shall not exceed an amount equal to the sum of

(a) the actual value of such consideration and the premiums, and
(b) other amounts subsequently paid by the transferee.

So if there is a transfer for value, the death benefit in excess of the policy owner's basis is generally income taxable.

Say that Jed transferred a $1,000,000 life insurance policy on his life to Milton, an unrelated third party, for $20,000. Assume also that Milton paid three annual premiums totaling $30,000 before Jed’s death.

At Jed’s death Milton would be entitled to receive a total of $50,000 ($20,000 plus $30,000) income tax-free, while the other $950,000 would be taxable at ordinary income tax rates.

Safe Harbors

Even if there has been a transfer in return for valuable consideration, Code Section 101(a)(2) says the policy proceeds will not lose their income-tax-free status

A. If such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or
B. If such transfer is to
   a. the insured,
   b. a partner of the insured,
   c. a partnership in which the insured is a partner, or
   d. a corporation in which the insured is a shareholder or officer.

What is the first safe harbor, which talks about basis? The short and simple answer is that it’s saying a gift is not a transfer for value.

When someone makes a gift of an asset, the donor’s tax basis in the asset transfers to the donee. Subsection A above says that if the recipient gets the donor’s basis in the transferred policy, the transfer for value rule does not apply. If the rule does not apply, the death benefit stays income tax-free. Furthermore, under Code Section 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. Therefore, even though spousal sale is for value, it qualifies for the Subsection A exception.

Subsection B lists a whole new set of transfers for value that will still leave the death benefits income tax-free. Each of these exceptions focuses on the identity of the transferee. A non-gift transfer from the insured to another person violates the transfer for value rule. On the other hand, a transfer from a third party to the insured is an exception—and the death benefit stays income tax-free.
tax-free. The insured, corporation where the insured is an officer or shareholder, and a partnership or partner of the insured are exempt transferees.

That means there is a four-part test to determine whether the transfer for value rule is a problem in any situation:

1. Is ownership of the life insurance policy—or any interest in it—being transferred?
2. Is the transfer for valuable consideration?
3. Is the transfer to a nonexempt transferee?
4. Is the transfer by the insured to the insured’s spouse?

If the answer to the first three questions is yes and the answer to the fourth question is no, the transaction is a transfer for value.

Unexpected Results

BUSINESS SITUATION

One of the more common situations where the transfer for value rule creates a minefield is where parties to a corporation’s funded buy-sell agreement are changing from redemption to cross-purchase structure.

Under a redemption arrangement, the company typically agrees to buy a deceased owner’s share of the company. To fund its obligation the company might own and be beneficiary of life insurance policies on the lives of each of the shareholders.

If the owners of the company decide to change the structure to cross-purchase, they might be tempted to transfer the old company-owned policies so the coverage is owned by the noninsured shareholders. Such a transfer would likely violate the transfer for value rule.

Why? Applying the test, the first question is whether ownership of the life policy is being transferred. Under the facts above, the answer is clearly yes.

Is the transfer for valuable consideration? Some might say that, because no money is changing hands, the transfer involves no value. However, that analysis isn’t sophisticated enough. Why would the company agree to allow the transfer of life policies from the company to noninsured shareholders? It’s because the company has a financial relationship with its owners. The company will transfer the policies to satisfy its obligation to its owners to pay a dividend or other compensation. If there’s a transfer to satisfy an economic promise, that’s a transfer for valuable consideration.

Is the transfer to a nonexempt party? Based on the limited facts, the answer is no. The parties to the buy-sell agreement are co-shareholders. The policies are being transferred to a co-shareholder of the insured to fund the buy-sell agreement. Co-shareholders of the insured are not exempt parties for transfer for value purposes, so the third part of the test is met as well.

Finally, the transfer is not from the insured to the insured’s spouse. Unless something is done, the policy’s death benefits will be income taxable.
The answer in this situation would be different if in addition to being co-shareholders, the owners of the company are also real business partners in another business enterprise. For example, they might all be partners in owning the real estate on which the business operates. If that is the case, the transfer of each policy would be to an exempt party—a partner of the insured.

There are more ways a corporate buy-sell situation can create a potential transfer for value situation. Say, for example, Jack, Janet, and Chrissy are three equal owners of a corporation. They decide to do a cross-purchase buy-sell agreement and fund the death trigger with life insurance.

To avoid having multiple policies on each life, they decide to use a trust to own the insurance on their lives and facilitate the buy-sell agreement. Each of them has a one-third interest in the trust and its potential benefits.

If Jack dies, the life insurance death benefit is paid to the trust. The trust is obligated to buy out Jack’s interest in the company from his estate, and it reallocates those shares equally to Chrissy and Janet.

If the trust and life insurance continue to stay in place to fund a new buy-sell arrangement between Chrissy and Janet, that may create a problem. If the trust is not carefully drafted, the surviving owners may have a transfer for value issue with regard to each other’s policies. Chrissy’s and Janet’s rights to the policy death benefits on each other’s policies may have increased due to Jack’s death and the subsequent buyout of his shares. It’s possible that the IRS may decide the change in rights is a transfer for value and that the subsequent death proceeds at the second owner’s death will be taxable.

The situation with Jack, Janet, and Chrissy is only a problem because they are shareholders and their buy-sell funding conduit is a trust. Couldn’t they be sure of solving everything if they fund their buy-sell with insurance owned by a partnership created only to facilitate the buyout? Maybe, although the IRS hasn’t said for sure.

NO PHYSICAL TRANSFER REQUIRED

Can the transfer for value rule be avoided if the transferor does not actually transfer the contract and sell it outright to the transferee? No! Any transfer can trigger the trap.

Nor is it required that every interest in the policy be transferred for the rule to be invoked. If the right to receive any or all of the economic benefits of a life insurance policy is transferred in return for valuable consideration, that will be sufficient to set the trap.

For instance, if Gene makes his brother, Gary, the beneficiary of a policy on Gene’s life in return for Gary’s transfer of ownership of a car, the requisite transfer has occurred. Similarly, if Gene names Gary beneficiary in return for Gary’s naming Gene beneficiary of a policy on Gary’s life, the requisite consideration has taken place. The creation for value of any enforceable contractual right to receive all or a portion of the proceeds will set the trap even if no physical transfer of the insurance policy was ever made.
COLLATERAL ASSIGNMENT

If someone can trigger a transfer for value without physically transferring the policy, can a collateral assignment create a problem? Fortunately, the answer is no. Treasury Regulations Section 1.101-1(b)(4) specifically says pledging a policy as security for a loan is not a transfer for value.

POLICY SUBJECT TO A LOAN

Say that Fred transfers a policy with a large loan against it to his son’s irrevocable trust but receives nothing in return from the trustee for the transfer. Will such a transfer be considered a transfer for value?

The IRS might treat the transfer of a policy subject to a loan as a transfer for value. The rationale is that the trust is, in essence, relieving Fred of the obligation to repay the loan. Although no actual payment has been made, the trustee’s acceptance of the policy is the same as the trustee’s paying Fred an amount equal to the outstanding loan.

But wouldn’t the transfer by gift meet the “same basis” exception of subsection A? It might, but only if the loan balance is less than Fred’s basis. In Private Letter Ruling 8951056, the IRS ruled that a policy loan balance is taxable consideration when the policy is transferred by gift. However, the loan balance only changes the basis of the policy if the loan is bigger than the transferor’s basis in the policy at the time of transfer.

If, for example, Fred’s basis in the policy is $10,000, and the loan balance is $8,000, the transfer of the policy to the trust will qualify for the Subsection A exception to the transfer for value rule. However, if the loan balance is $12,000, the trust’s basis in the policy would be bigger than Fred’s, and the transfer for value rule would be triggered.

TERM INSURANCE

On occasion a life insurance agent will say that the transfer for value rule is irrelevant because the client is seeking to transfer only term insurance. The issue commonly comes up when a term policy is owned by a business and the company is seeking to transfer the policy to the owner of the company. Because term insurance has no value, the argument goes, the policy cannot possibly be subject to the transfer for value rule.

Wrong! If a term insurance policy really had no value, why would the transferee be interested in owning it? Term insurance is potentially valuable for a number of reasons:

- It may have a partial year of death benefit that has already been paid for by the transferor.
- It may allow the new policy owner to continue coverage at a predictable premium without having the insured go through the inconvenience and uncertainty of new underwriting.
- It may have a guaranteed conversion privilege to a policy priced at the term policy’s rate class.

Each of these features has value. So when term insurance is transferred by the company, transfer for value analysis must be applied. Companies do not make gifts to owners or
employees, so the transfer does not qualify for the Subsection A exception. Most such transfers will qualify as a Subsection B exception, a transfer to the insured. However, if the transfer is not made to an exempt person, a transfer for value problem is triggered.

**FIXING A PROBLEM**

So if a policy is transferred for valuable consideration, are the death proceeds permanently tainted? Not necessarily. A subsequent transfer of the policy to an exempt transferee will fix the transfer for value problem. See Treasury Regulation 1.101-1(b)(3)(ii).

Consider the example described earlier where the co-shareholders of a corporation transferred corporate-owned policies to noninsured shareholders. That transfer created a transfer for value problem. However, the problem could be solved by changing the buy-sell structure back to entity purchase, along with the transfer back to the company of the cross-owned policies. In that case the final transfer—to a corporation where each insured is an officer or a shareholder—is a transfer to an exempt party. The final exempt transfer cures the problem.

**PLR 201235006**

**OVERVIEW**

In PLR 201235006, the IRS approved the income tax treatment of the sale of a life insurance policy by one trust to another. The taxpayer believed the death benefit of any life insurance owned by the selling trust would be included in the taxpayer's taxable estate. One of the objectives of the sale was to remove the death proceeds from the taxpayer's estate by moving the policy to an irrevocable life insurance trust (ILIT).

The acquiring ILIT was drafted, according to the PLR, as a grantor trust. A grantor trust is treated as the alter ego of the trust grantor for income tax purposes. Estate-planning attorneys often draft irrevocable life insurance trusts (ILITs) so the proceeds of trust-owned life insurance are excluded from the grantor's estate for estate tax purposes. However the ILIT and its income are considered to be owned by the grantor for income tax purposes.

The acquiring ILIT became a grantor trust because it included language that allowed the grantor to remove an asset from the trust by replacing it with an asset of equivalent value. Code Section 675 says that giving the grantor such a power makes the trust a grantor trust.

In the PLR, the IRS said that the sale of the policy to a grantor trust was considered to be a transfer of the policy to the insured and thus an exception to the transfer for value rule under Subsection B:

> The transfer of the life insurance contract to a grantor trust that is treated as wholly owned by the insured is a transfer to the insured within the meaning of § 101(a)(2)(B) and therefore is excepted from the transfer for value limitations of § 101(a)(2).

The logic applied in the PLR with regard to the transfer for value rule is the same position the Service set forth in Revenue Ruling 2007-13.

Does giving the grantor the power to reacquire the life policy from the trust by substituting an asset of equal value cause the insurance death benefit to be included in the grantor's estate?
The IRS said no. While its ruling may not be relied on as a final authority, it is an indication of how the IRS analyzes the issues contained in the ruling.

OPPORTUNITIES

If a sale of a policy to an ILIT taxed as a grantor trust does not trigger a transfer for value problem, it creates a number of solutions to problems faced by estate-planning attorneys and their affluent clients.

Here’s one example. Say the insured owns an insurance policy on his life. The insured decides she wants to remove the policy’s death benefit from her taxable estate. She knows if she makes a gift of the policy to an ILIT or to her adult children, she must survive the transfer by three years before the death proceeds will be estate tax-free.

But what if she creates an ILIT taxed as a grantor trust with the same kind of substitution provision as in the PLR? What if she funds the trust with cash and then sells the policy to the trust for its fair market value?

The three-year rule only applies to gifts of life policies, not sales, so that problem should be avoided. The IRS has also decided in Revenue Ruling and PLR that the sale of the policy to a grantor trust does not trigger the transfer for value rule.

The biggest tax risk of the transaction is that the IRS might change its mind about whether a substitution of asset provision in an ILIT still keeps the death benefit out of the estate. Does that tax risk outweigh the risk of three-year inclusion? The answer depends on the facts of the situation.

Here’s another way the logic of the PLR might be used. Say that Charlie creates an irrevocable trust for the benefit of his wife and children. The ILIT purchases and owns insurance on Charlie’s life.

Later on, the marriage ends, and Charlie starts a new family with a new spouse. Charlie wants his children from the new relationship to share in the death benefit of the life insurance policy with his older children. Assume the ILIT is written in such a way that the trustee of the existing ILIT cannot add the younger children as beneficiaries without violating the trustee’s duty to the older kids.

To solve the problem, Charlie’s attorney creates a new ILIT structured as a grantor trust. The new trust favors Charlie’s younger children as beneficiaries. Charlie seeds the new ILIT with a substantial initial gift.

The trustee of the new trust negotiates with the trustee of the old one to buy the existing policy on Charlie’s life for a fair price. After the sale the result is that the older kids—beneficiaries of both trusts—and the younger kids—who are beneficiaries of just the newer ILIT—are treated roughly equally.

Under the logic of the PLR, Charlie is able to accomplish his new estate-planning objectives by selling the policy on his life to the new trust and avoids adverse transfer for value issues.
CONCLUSION

Life insurance professionals rightly promote the fact that the death benefit of a life insurance policy is income tax-free. However, if the transfer for value rule is triggered, the otherwise tax-free death benefit becomes taxable.

The key to avoiding the trigger of the transfer for value problem is to make sure any transfer—outright or subtle—qualifies for one of the exceptions:

- The transfer is treated as a gift, or
- The transfer is to an exempt person.

In PLR 201235006, the IRS decided that a sale of a policy to the insured’s grantor trust qualifies as a transfer to an exempt person and is thus immune from the transfer for value trap. The logic of the private letter ruling can help solve some estate and business planning problems for our clients.

Policy loans and withdrawals will reduce the cash value and face amount of the policy. Clients may need to fund higher premiums in later years to keep the policy from lapsing.

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