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FINANCIAL PLANNING

Transfer-For-Value: What You Really Need to Know

THE BIG PICTURE

The general purpose for the purchase of a life insurance policy is to provide an income-free death benefit for the beneficiaries of the deceased individual. One of the major benefits of a life insurance policy would be lost if the policy's death benefit became taxable. Is this possible? Yes – it is. How would you, as a beneficiary, know if the life insurance in force on your loved one is going to be taxable to you?

One of the most common ways to have the death benefit become taxable is to transfer ownership of the policy during the lifetime of the insured.

Of course, not every transfer will make the death benefit taxable, but the potential is there, so taking precautions is important. The worst time to find out that a transfer has made the death benefit taxable is after the death of the insured. Up to that point, it is possible to rectify the situation. With this caution about the necessity to be vigilant in regard to transfer-for-value, let's talk about what it is.

Transfer-for-value is the rule that states that if a life insurance policy (or interest in said policy) is transferred for something of value – whether it be money, property, or mutual promises – a portion of the death benefit is subject to being taxed as ordinary income. That portion is equivalent to the death benefit minus the value of the item received in exchange for the policy, as well as any premiums paid by the transferee after the transfer.

Here is a Simple Example:

Jane Smith sells her $500,000 life insurance policy to her friend John James for $10,000. After the sale and before Jane's death, John pays $50,000 in premiums. The amount subject to tax is $440,000 ($500,000-$50,000-$10,000). Upon Jane's death, John would have income of the $440,000 added to his income that year, potentially causing him to lose a significant amount of that benefit in taxes.

Using the numbers in the example above, let's change the scenario a little. Imagine if John was not a friend, but a child of Jane's who had purchased the policy. If John was counting on receiving 100% of the money to settle his mom's estate and have funds to live on, this error could have a dramatic impact.

Can a Transfer-For-Value Occur Based Upon How a Beneficiary Arrangement is Structured?

Yes. Sometimes business buy-sell arrangements are set up with shareholders owning their own life insurance policy and naming each other as beneficiary. Even though the ownership of the policies themselves were not transferred, the structure of this arrangement would cause a transfer-for-value. Each shareholder is naming the other as beneficiary because of their mutual promises. The bargained-for exchange causes a transfer-for-value of the death benefit.

Now that it is clear how transfer-for-value works, let's look at ways to avoid this problem. The tax code offers a few exceptions to the rule. These include:

1. A transfer to the insured;
2. A transfer to the partner of the insured;
3. A transfer to a partnership in which the insured is a partner;
4. A transfer to a corporation in which the insured is a shareholder or officer; or
5. The gift of a life policy (basis carries over).

Let's Take These Exceptions One at a Time.

Transfer to the Insured:

Any time a policy is transferred to the insured, even if it would otherwise be a transfer-for-value, the death benefit remains non-taxable.

Transfer to a Partner of the Insured:

If the policy is transferred to a person who is an official partner of the insured on the policy, the death benefit will remain non-taxable.

Transfer to a Partnership in Which the Insured is a Partner:

A policy may be transferred to have a partnership own the policy on the insured as long as the insured is a partner in the partnership.

Transfer to a Corporation in Which the Insured is a Shareholder or Officer:

Similar to the previous exception, a policy may be transferred to the ownership of a corporation as long as the insured is a shareholder or officer. This can be either an S Corporation or a C Corporation; no distinction is made.

> **Important Note:** Transfer to another shareholder/officer in the corporation of which the insured is a shareholder/officer is NOT an exception to the rule. This is an important distinction, especially when the policy is being used for business planning, as may be the case with a buy-sell arrangement in a corporation. After the death of a shareholder, the interest in the policies that he or she owned on the surviving shareholders is often redistributed, potentially causing a transfer-for-value issue.

The Gift of a Life Policy (Basis Carry Over)

This exception is also known as the "basis carry over exception" and means that where the transferee is required by tax law to carry over all or some of the basis of the transferor, the proceeds are tax-free. This can come into play when an outright gift of life insurance was made, such as a gift from parent to child. This would avoid transfer-for-value under this exception as long as the child had given nothing to the parent in return. This may also work in a business setting.

For instance, in a situation where there is a corporate reorganization and the business transfers a policy it owns on an employee to another corporation as part of the reorganization strategy. The corporation gaining receipt of the policy may carry over the basis of the transferring corporation, so the proceeds may remain tax free when the insured dies.

> **Important Note:** If there is a significant loan against the policy, potentially the transfer no longer falls under an exception to the transfer-for-value rule. This may be true if the loan is greater than the policyowner's basis in the policy.

Another question often asked is whether a policy with no cash value is subject to transfer-for-value. The answer is unequivocally YES. Transfer-for-value applies to all types of life insurance, not just insurance with a cash value.

In summary, due to the complexities of this rule, it is very important that you approach all transfers of life insurance very carefully. There can be a significant penalty if done incorrectly.

Contact your tax advisor and/or legal professional prior to making transfers of policies to ascertain whether the transfer being considered will potentially cause taxation of the death benefit.

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