Because You Asked

Advanced Markets

Understanding transfer-for-value & reportable policy sales

Beneficiaries of a life insurance policy typically receive the death benefit income tax-free. One notable exception to this general rule is if ownership of the policy (or other rights) is transferred during the insured's life for valuable consideration or as part of a reportable policy sale.

Frequently asked questions

1. How are life insurance death benefits generally taxed?

The general rule under IRC §101(a) is that life insurance death benefits are received by the policy's beneficiaries income tax-free. Specifically, §101(a)(1) provides that a taxpayer's gross income does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured.

2. What is the transfer-for-value rule?

In situations where an interest in a life insurance contract, or the death benefit, has been transferred for a "valuable consideration," the death benefit becomes subject to income taxes unless an exception applies (see below).[1] The amount of the death benefit that is subject to income taxes is the excess of the death benefit over the amount actually paid for the interest in the contract plus any premiums and other amounts[2] paid by the transferee following the transfer. Both permanent and term life insurance policies are subject to the transfer-for-value rule.[3]

Example

A pays premiums of $500 for an insurance policy in the face amount of $1,000 upon the life of B, and subsequently transfers the policy to C for $600. C receives the proceeds of $1,000 upon the death of B. The amount which C can exclude from his gross income is limited to $600 plus any premiums paid by C subsequent to the transfer.

3. What constitutes "valuable consideration?"

A transfer for valuable consideration is any absolute transfer-for-value of a right to receive all or a part of the proceeds of a life insurance policy. This not only includes a transfer of a policy in exchange for money or money's worth, but extends to more than just money. For example, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for valuable consideration of the policy or an interest therein. On the other hand, the pledging or assignment of a policy as collateral security is not a transfer for valuable consideration of such policy or an interest therein, and §101 is inapplicable to amounts received by the pledgee or assignee.

4. What are the exceptions to the transfer-for-value rule?

There are several exceptions to the transfer-for-value rule provided by §101(a)(2)(A) and (B). Specifically, the death benefit will not be subject to income taxes, even in the case of a transfer of the policy, or an interest in the policy, if the transfer is to:

- The insured;
- A partner of the insured;
- A partnership in which the insured is a partner;
- A corporation in which the insured is a shareholder or officer; or
- If the transferee's basis in the transferred policy is determined, in whole or in part, by the transferor's basis in the contract (i.e., "the carryover basis" exception).

Example 1

The X Corporation purchases for a single premium of $500 an insurance policy in the face amount of $1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. Prior to the death of A, the X Corporation transfers the policy to the N Corporation, in which A is a shareholder. The N Corporation receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of the N Corporation.

Example 2

The X Corporation purchases, for a single premium of $500, an insurance policy in the face amount of $1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. The X Corporation transfers the policy to the Y Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Y Corporation determined by reference to its basis in the hands of the X Corporation). The Y Corporation receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of the Y Corporation.

Note, however, that none of the aforementioned exceptions apply if the transfer is considered a reportable policy sale. Additionally, even if a transfer does qualify for one of the aforementioned exceptions, if a reportable policy sale occurred prior to the transfer, some portion of the death benefit may still be subject to taxation. See the discussion of “reportable policy sales” in question 9.

5. If a policy is acquired by gift does the transfer-for-value rule apply?

Generally, if a policy is acquired by gift, the transfer-for-value rule will not apply because the transferee’s basis will be the same as the transferor’s basis. Transfers between spouses or former spouses incident to divorce are also treated the same as gifts for tax purposes.

When a policy is transferred by gift, the amount of proceeds excluded from income is equal to the amount that would have been excluded by the transferor had the transfer not occurred. If a reportable policy sale has occurred prior to the gift of the policy, a portion of the death benefit may be income taxable to the recipient.

Example

A, the insured, sells her policy to B for $10,000. The sale constitutes a reportable policy sale because B has no substantial family, business or financial relationship with A. The following year, B gifts the policy on A’s life to C, A’s child, who does have a substantial family relationship with A. At A’s death, C receives $100,000. The amount of death benefit excludable from C’s income is equal to $10,000 (the amount that would have been excludable by B if the transfer had not occurred) plus any premiums paid by C following the gift.

In the case of a gift of a policy subject to a loan, the transfer is treated as a part-gift/part-sale and will trigger a transfer-for-value. If the loan is less than basis, there will be no transfer-for-value issue because the transferee will take the same basis as held by the donor (i.e., the “carryover basis” exception applies). If, however, the loan is greater than the basis in the contract, the basis to the transferee is determined using the loan amount and the basis exception will not apply, unless another exception to the transfer-for-value rules apply.

6. Does a transfer between a grantor and his/her grantor trust constitute a transfer-for-value? What about a transfer between two grantor trusts with the same grantor?

The IRS held in Rev. Rul. 85-13 that the transfer of assets between a grantor and his grantor trust will not be treated as a sale for income tax purposes, which suggests that a sale between and grantor and his/her grantor trust is not a "transfer" within the meaning of §101(a)(2).[4]

Applying Rev. Rul. 85-13, the IRS held that a transfer between two grantor trusts with the same insured/grantor is not a transfer for the purposes of the transfer-for-value rule.[5] Because the grantor is treated as the owner of both trusts for income tax purposes, the grantor is treated as the owner of both the life insurance contract and the cash received for it both before and after the exchange, therefore there is no "transfer" under §101(a)(2).

Although no "transfer" is deemed to have occurred for the purposes of the transfer-for-value, the transfer of the life insurance policy could constitute a reportable policy sale if the beneficiaries of the trust do not have a substantial family, business, or financial relationship with the insured.

7. Does a transfer from a non-grantor trust to a grantor trust constitute a transfer-for-value?

Yes, but an exception may apply. The sale of a life insurance policy from a non-grantor trust to a grantor trust is a transfer for valuable consideration within the meaning of §101(a)(2).[6] However, if the grantor trust is wholly owned by the insured, the transfer will be treated as a transfer to the grantor/insured and will fall under the "transfer to the insured" exception in §101(a)(2)(b). In most cases, the beneficiaries of such a trust will be the family members of the grantor/insured, meaning that the transfer will not constitute a "reportable policy sale" as discussed below. If, however, the transfer constitutes a reportable policy sale, then the "transfer to the insured" exception would not be available, and the transfer would cause at least a portion of the death proceeds to be income taxable.

8. Is there a way to cure a transfer-for-value that did not meet one of the exceptions?

Maybe.

In the case of a series of transfers, if the final transfer is to the insured, partner of the insured, partnership in which the insured is partner or to a corporation in which the insured is a shareholder/officer, AND no reportable policy sales have occurred along the way, the final transferee should be able to exclude the entire death benefit from gross income, assuming such final transfer does not constitute a reportable policy sale.

If a reportable policy sale has occurred prior to the transfer to a partner of the insured, partnership in which the insured is a partner, or corporation in which the insured is a shareholder/officer, the amount of the death benefit excluded from tax is limited to the sum of:

(i) The higher of the amount that would have been excludable by the transferor if the transfer had not occurred, or the actual value of the consideration paid by the transferee; AND

(ii) The premiums paid by the transferee.

If the final transferee in a series of transactions following a reportable policy sale is the insured, and the insured acquires the policy for valuable consideration at its fair market value, then the entire death benefit can be excluded from income tax.

9. What is a "reportable policy sale?"

The Tax Cuts and Jobs Act of 2017 added a new provision (IRC §101(a)(3)) under the transfer-for-value rules related to "reportable policy sales."

A "reportable policy sale" is defined generally as the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract).

When a policy is acquired as part of a reportable policy sale, the portion of the death benefit that exceeds the owner's basis in the contract will be subject to income tax. This new provision further provides that **none of the exceptions to the transfer-for-value** rules apply when a life insurance contract, or any interest in a life insurance contract, is transferred in a reportable policy sale.

10. What is a "substantial family, business, or financial relationship" for reportable policy sale purposes?

As defined in Treasury Regulation §1.101-1(d):

A substantial family relationship includes the following relationships of the acquirer to the insured: (1) same person, (2) a spouse (including domestic partners and other legal relationships permitted under state law), (3) a parent, grandparent, or great-grandparent (or the spouse of such), (4) a lineal descendant of any of the foregoing (1) , (2), or (3) (or the spouse of such lineal descendant), or (5) any lineal descendant of a person described in (4).

A former spouse is also considered to have a substantial family relationship with the insured if a transfer is incident to a divorce.

A substantial business relationship between the acquirer and the insured exists in each of the following circumstances:

- The insured is a key person or materially participates (as owner, employee, or contractor) in an active trade or business owned directly or indirectly by the acquirer, AND at least 80% of the business is owned (directly/indirectly) by the acquirer or beneficial owners of the acquirer
- The life insurance policy is owned by a business that is acquired by the acquirer and the acquirer carries on the acquired business or uses a significant portion of the assets in an active trade or business, assuming one of the following additional requirements is met:
  - The insured, immediately before the acquisition, is an employee of the acquired business; OR
  - Was director, highly compensated employee, or highly compensated individual AND, immediately after the acquisition, the acquirer has an ongoing financial obligation to the insured (e.g., nonqualified deferred compensation, pension plan, buy/sell, etc.)

A substantial financial relationship between the acquirer and the insured exists in each of the following circumstances:

- Acquirer acquires the insurance to fund the purchase (at insured's death) of insured's assets, liabilities, or interests in common investments with acquirer.
- Acquirer is a charity to which insured has been a substantial contributor or volunteer.

It is important to note that some circumstances where parties may appear to have a substantial family, business, or financial relationship do not qualify as such as defined by the final regulations.

Example

"A is the initial policyholder of a $100,000 insurance policy on A's life. A contributes the policy to a C corporation, Corporation W, in exchange for stock. After the acquisition, A owns less than 20% of the outstanding stock of Corporation W and owns stock possessing less than 20% of the total combined voting power of all stock of Corporation W (and is therefore not a key person, as defined in the Regulations, with respect to Corporation W). Corporation W's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. However, no substantial family, business, or financial relationship exists between A and Corporation W, so A's contribution of the policy to Corporation W is a reportable policy sale. Corporation W receives the proceeds of $100,000 on A's death. Thus, the amount of the proceeds Corporation W may exclude from gross income is limited to the actual value of the stock exchanged for the policy, plus any premiums and other amounts paid by Corporation W with respect to the policy subsequent to the transfer. The "shareholder or officer" exceptions to the transfer-for-value rule do not apply because the transfer to Corporation W is a reportable policy sale." (This is from Treasury Regulation §1.101-1 Example 12)

Planning note

Prior to the reportable policy sale rules, the transaction discussed in Example 12 would have not previously caused the death benefit to become taxable under §101 as it would have satisfied one or both of the following transfer-for-value exceptions: (i) transfer to a "corporation in which the insured is a shareholder or officer" or (ii) where the transferee takes the same basis as the transferor" However, because the regulations identify the transfer as a reportable policy sale, no transfer-for-value exceptions will apply to keep the policy from being subject to income tax

11. What are the reporting requirements related to a reportable policy sale?

Anyone who acquires a life insurance contract or interest in a life policy in a reportable policy sale must file a Form 1099-LS with respect to each life insurance policy acquired (or interest acquired).

The 1099-LS requires information about the acquirer, including name, address, telephone number, and taxpayer identification number (TIN). This form also requires the name, address and TIN for each payment recipient, name of the issuer, policy number of the contract(s), the amount paid to the payment recipient, and the date of sale.[8]

A copy of the 1099-LS must be sent to each payment recipient and the issuer of the policy.

Upon receipt of the 1099-LS (or comparable statement providing this information), the policy issuer must also provide to the IRS information related to the seller, including the name, address, TIN of the seller, seller's investment in the contract, and the policy number of each contract. Upon the death of the insured following a reportable policy sale, the payor of the death benefit must also furnish information regarding the name, address, TIN of each recipient, date of each payment, gross amount of each payment, ad estimate of the investment in the contract with respect to the buyer.

To give acquirers and issuers ample time to develop and implement reporting systems, Treas. Reg. §1.101-1 provides that no reporting is required for reportable policy sales made and reportable death benefits paid after December 31, 2017, and before January 1, 2019.

12. What are the effective dates related to reportable policy sales?

The provisions discussed in this BYA are generally effective for reportable sales entered into, and reportable death benefit received, after December 31, 2017.

As noted in the previous question, to give acquirers and issuers ample time to develop and implement reporting systems related to reportable policy sales, Treas. Reg. §1.101-1 provides that no reporting is required for reportable policy sales made and reportable death benefits paid after December 31, 2017, and before January 1, 2019.

The effective date of the updated final regulations, Treas. Reg. §1.101-1, is October 31, 2019.

13. Are there any exceptions to the definition of a reportable policy sale?

Yes, the regulations provide that none of the following transactions are considered "reportable policy" sales:

1. Transfers between entities with the same beneficial owners if the ownership interests of each beneficial owner in both the transferring entity and the transferee entity do not vary by more than 20%;
2. Transfers between corporations that are members of an affiliated group (as defined in the Regs) that files a consolidated income tax return in the year transfer is made;
3. Person acquires ownership interest in a partnership/trust or other entity (directly or indirectly) that owns a life policy if the entity acquired the interest in the policy (i) before January 1, 2019 or (ii) in a reportable policy sale and complied with the requirements for such sales
4. Immediately before person acquires an interest in a partnership/trust/entity owning an interest in the life policy:
   (i) No more than 50% of the gross value of the assets held by the partnership/trust/entity consist of life insurance contracts, and
   (ii) Following the acquisition, the person acquiring the interest in the partnership/trust/entity and his/her family members own, in the aggregate:
      a. For S corps: 5% or less of total combined voting power of all voting stock and 5% or less of total value of shares of all classes of stock
      b. For trusts/estate: 5% or less of the corpus and 5% or less of annual income
      c. For partnerships: 5% or less of capital interest and 5% or less of profits interest
5. Person acquires ownership interest in a C Corp and 50% or less of the gross value of the assets of the C Corp consist of life insurance contracts immediately before person acquires its interest
6. Acquisition of a life contract by an insurance company that issues life insurance contracts in an exchange pursuant to §1035
7. Acquisition of a policy in a §1035 exchange if the policy holder has a substantial family, business or financial relationship with the insured at the time of the exchange

Planning note

Reportable policy sales and the exceptions to that definition are complex. Clients should consult with their tax advisors prior to the acquisition or transfer of a life insurance policy or an interest in a partnership, trust, or other entity that owns life insurance.

14. Do the reportable policy sale rules apply to 1035 exchanges?

In some situations.

As discussed in the preceding question, acquisition of a life contract by an insurance company that issues life insurance contracts in a §1035 exchange is not considered a reportable policy sale.

With respect to policies owned by anyone other than an insurance company, replacing a policy as part of a §1035 exchange will be a reportable policy sale if the policy owner lacks a substantial family, business or financial relationship with the insured at the time of the exchange.

Example

A, a corporation, purchased a policy on B, a key employee at the time the policy was issued. A later replaces the policy in a §1035 exchange at a time when B is no longer working for the company and the company has no financial responsibilities with respect to the insured. Because A lacks a substantial business or financial relationship with respect to the insured, the replacement of the policy would be considered a reportable policy sale.

15. Is there a way to cure a reportable policy sale?

Yes, but only if the policy is transferred to the insured for full and adequate consideration.

Example

"A is the initial policyholder of a $100,000 insurance policy on A's life. A transfers the policy for $6,000, its fair market value, to an individual, C, who does not have a substantial family, business, or financial relationship with A. The transfer from A to C is a reportable policy sale. Before A's death, C transfers the policy back to A for $8,000, its fair market value. A's estate receives the proceeds of $100,000 on A's death. The transfer from C to A is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A. Although the transfer follows a reportable policy sale (the initial transfer from A to C), A's estate may exclude all of the policy proceeds from gross income..."

As explained in other rather complicated examples from the final regulations, had A paid less than full and adequate consideration for the final acquisition of the policy, some portion of the death benefit from the policy would have been income taxable to A's estate. (This is from Treasury Regulation §1.101-1 Example 6)

1. §101(a)(2).
2. The phrase "other amounts" includes interest paid or accrued by the transferee on indebtedness with respect to such contract, or any interest therein if such interest paid or accrued is not allowable as a deduction under §264(a)(4).
3. See *James F. Waters, Inc. v. Commissioner,* 160 F. 2d 596, holding that a transfer-for-value can occur even though the policy transferred has no cash surrender value.
4. Rev. Rul. 85-13.
5. Rev. Rul. 2007-13.
6. Rev. Rul. 2007-13.

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