first part of a two-part article analyzes the rule and its exceptions.

TRANSFER FOR VALUE RULE

AVOIDING THE TAX TRAP OF THE TRANSFER FOR VALUE RULE

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Life insurance proceeds are generally received income tax-free, but failure to avoid the transfer for value rule may result in a loss of the exclusion from income. This awareness of the transfer for value rule and its potentially draconian dangers is crucial in planning personal or business life insurance transactions. Every transfer of a life insurance policy or even of an interest in a life insurance policy during the insured’s lifetime should be considered suspect, until it is scrupulously checked and each element of the transfer for value rule is examined.

Income tax exclusion for life insurance proceeds

One of the most important exceptions to the general rule that all income from whatever source derived is taxable is the one which 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 exclusion for life insurance proceeds paid at death applies not only to lump-sum amounts, but also to installment payments (any interest paid by the insurer on the unpaid balance is, however, taxable). Policy death proceeds are excludable for income tax purposes, regardless of whether the payment is made to the insured’s estate or to an individual, partnership, limited liability company (“LLC”), or other entity (such as a charity), named as the policy beneficiary. The exclusion is available regardless of the type of life insurance involved, and regardless of whether the insurance proceeds are paid to a beneficiary directly or to a trustee or custodian for his or her (or its) benefit. There
is no limitation on the amount of life insurance proceeds that can be received income tax-free at the insured’s death.

**Transfers for value: Exception to general exclusion**

Nevertheless, there is an exception to the broad income tax exclusion for life insurance. This provision can cause a disastrous loss of the favorable income tax treatment afforded to life insurance proceeds, as illustrated by Exhibit 1. That exception is called the transfer for valuable consideration or more commonly, the “transfer for value,” rule.6

The transfer for value rule provides that where there has been a transfer of a life insurance contract—or, importantly, any interest in a contract—for any type or form of valuable consideration (in money or money’s worth),7 the entire insurance proceeds (less the consideration paid for the policy or interest in the policy plus premiums and other amounts paid by the transferee after the transfer) are includable in the gross income of the beneficiary.

For example, if a $1 million term insurance policy on an insured’s life is transferred from the insured to his sister in return for her payment of $1,000, there has been a transfer of an insurance contract for value. At the insured’s death, if the transferee had paid two $1,200 premiums, the amount excludable from the beneficiary’s income for amounts received under the policy is limited to the value of the consideration paid for the policy ($1,000) plus the total premiums subsequently paid ($2,400). Thus, $1,000,000 less $3,400, $996,600, would be subject to ordinary income tax. The tax in 2005 would be in excess of $327,000!

**Scope of the rule is broad.** The method of transfer of the policy or interest in the policy is irrelevant for purposes of this rule. The transfer for value rule applies in the case of any absolute transfer of a life insurance policy—or an interest in a policy—regardless of whether the transfer resulted from an absolute assignment of all the transferor’s rights or a transfer of some lesser degree of policy rights or a different type of transfer. There is no de minimis rule exempting small transfers.

The phrase “transfer for valuable consideration” is broadly defined. It encompasses any absolute transfer—for value—of a right to receive all or any part of a life insurance policy. The income tax Regulations include in this definition the creation for value of an enforceable contractual right to receive all or any part of the proceeds.8 If the insured in the prior example had merely named his or her sister as the beneficiary of the policy for valuable consideration, that alone would be a transfer for these purposes, even though no “transfer” of the policy’s ownership had occurred.

**Exclusions from the transfer for value rule.** A pledge or assignment of a policy (or an interest in a policy) as collateral security is specifically excluded from the definition of a “transfer” for these purposes.9 A pledgee or assignee who has received the pledge or assignment of a policy as collateral security for a loan will be able to receive the death benefit income tax-free10 (but as a repayment of capital, rather than as the proceeds of a life insurance policy).11

**The six safe harbors**

A beneficiary can receive insurance proceeds income tax-free—even if there has been a transfer of an interest in a policy for valuable consideration—in any one of six circumstances. These six “safe harbor” situations consist of a so-called “transferor’s basis” exception12 and five so-called “proper party” exceptions:13

**Transferor’s basis exception.** The first of the six14 safe harbors is commonly called the “transferor’s basis” exception. This safe harbor applies where the transferee’s basis in a policy or an interest in a policy is determined “in whole or in part” by reference to the transferor’s basis. The most elemental example is where the insured gives the policy to another party “for love and affection”; here, there is a gift with no consideration paid in return for the policy. An outright gift of life insurance with absolutely no payment of any kind received in return is the clearest instance of this exception.

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6 See Section 101(a)(2).
7 As discussed below, the concept of “value” for purposes of this rule is extremely broad, and can include the mutuality of consideration in an agreement. See the text at note 45, infra.
8 Reg. 1.101-1(b)(4).
9 Id.
10 See Ltr. Rul. 8628007. The result in this ruling should be examined under the part-gift/part sale analysis.
11 Id. It is unclear whether the Section 101(a)(1) general exclusionary rule is inapplicable to amounts received by the pledgee or assignee or whether the Section 101(a)(2) exception for transfers for value to that exclusionary rule are inapplicable to amounts received by the pledgee or assignee; presumably the first meaning is intended, so that the assignee receives the proceeds tax-free, as a return of capital.
12 Section 101(a)(2)(A); the “transferor’s basis” exception.
13 Section 101(a)(2)(B); the “proper party” exceptions.
14 Technically, there are only five safe harbors, but Section 1041 in essence creates an interspousal transfer safe harbor, albeit through the mechanism of the “carryover basis” exception. See the text at note 40, infra.
But even if some consideration is received in return for the transfer of the policy, if there is more gift than sale involved, the transferor’s basis safe harbor may still apply. For instance, assume that an insured sells his son a $100,000 policy on his life for $100, when the policy’s value was $1,000. The son’s basis (for determining gain or loss upon a subsequent sale) would be the father’s basis in the policy (the net premiums he has paid less any policy dividends received as a return of basis, perhaps reduced by the mortality costs incurred\(^{15}\)), with an adjustment for any gift taxes the father may have paid on the transfer.\(^{16}\)

The son’s basis is determined—at least in part—by his father’s basis, because even though there was (in part) a sale of a policy, to the extent of $900 ($1,000 value less $100 consideration paid), there was a gift. Where the “gift” proceeds exceed the “sale” proceeds, basis is determined by carrying over (with an adjustment for any gift taxes paid) the donor’s basis.\(^{17}\) In this case, the entire proceeds would be received income tax-free, because the son’s lifetime basis in the policy was determined “in part” by referring back to the basis of the policy in his father’s hands.

**Beware:** If, conversely, the transaction is “more sale than gift,” this carryover basis safe harbor will not apply! In other words, if the transferor’s basis on the date of the transfer is less than the total consideration paid by the transferee, (e.g., if the policy loan and/or cash or property received in the transaction are greater than the transferor’s basis), the transaction will be taxed under “sale” rather than “gift” rules.

This would take the transaction out of the “carryover basis” safe harbor and, absent another safe harbor, would result in ordinary income tax on a portion of the policy proceeds.\(^{18}\)

This is often the case where the transferor borrows on the policy in anticipation of making the transfer, to reduce the policy’s gift tax value, since actual cash received is added to the loan the transferor is relieved of paying in computing the total consideration the transferor received.\(^{19}\) If the sum of (1) any loan proceeds received plus (2) any cash received exceeds the transferor’s basis, there is no protection under this exception from the transfer for value rule. Policies with outstanding loans—where there would be taxable gain if the policy were sold (i.e., where the loan proceeds are greater than the transferor’s basis)—should always be suspect.

**Also beware:** This “transferor’s (carryover) basis” exception applies only if the transferor held an otherwise untainted policy for transfer for value purposes. In other words, if a policy is already subject to the transfer for value rule in the hands of its present owner, the transferor’s basis exception will not eliminate the taint on a subsequent transfer, because the transferee of a tainted policy steps into the shoes of the transferor.

Accordingly, even if the last transfer is a gift and no consideration has been given by the transferee for the policy, the policy will still be subject to the transfer for value rule—if it was already subject to the rule in the transferor’s hands. At the death of the insured, the policy owner can exclude from income only: (1) the total amount the last transferor could have excluded had the insured died while the last transferor owned the policy, plus (2) premiums and other amounts paid by the transferee after the final transfer.

Only if the final transferee is one of the five “proper parties” described below will the taint be removed. Of course, if that proper party then makes a gratuitous transfer, the transferee will take the policy free of the transfer for value risk. On the other hand, the taint will re-attach if the last transfer is for valuable consideration; in that case, the transferee will be able to exclude only the consideration paid plus premiums and other amounts paid after receiving the policy.

**The five ‘proper party’ exceptions**

1. **Where the policy or the interest in the policy is transferred to the insured.** For example, suppose that an insured purchased an existing $5 million policy on his life from his co-shareholder for its fair market value (“FMV”) (assume $300,000). Even though there was a transfer from the co-shareholder and the transfer was in return for valuable

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\(^{15}\) See Ltr. Rul. 9443020 and ILM 200501004, both taking the position, without citing any authority, that basis in a policy is reduced by the cost of the insurance protection “consumed” by the owner, which, according to the letter ruling, can be approximated by the difference between the premiums paid and the policy’s cash value. But see Section 72(e) (dealing with investment in the contract) and, e.g., Gallun, 327 F.2d 809, 13 AFTR2d 660 (CA-7, 1964), not requiring such a reduction in basis.

\(^{16}\) Section 1015(d).


\(^{18}\) To the extent the transferor has borrowed an amount greater than his/her cost basis, the absolute transfer of the policy will also trigger an immediately taxable gain. It’s as if the transferor had sold the policy to the transferee on the date of the transfer for the amount of the loan. See Gallun, supra, note 15. If, however, the purchaser is a grantor trust of which the seller is treated as the owner for income tax purposes, the gain will not be recognized. See Rev. Rul. 85-13, 1985-1 CB 184. In addition, as discussed in Part 2 of this article, such a transfer will be ignored for income tax purposes, so the transfer for value rule won’t apply.

\(^{19}\) Reg. 1.1001-2(a)-Reg. 1.1001-2(c).
consideration, the insurance proceeds would be income tax-free because of the “transfers to the insured” safe harbor exception. Similarly, if a grantor trust that is considered the alter ego of the insured for income tax purposes under the grantor trust rules is the transferee, that transaction will remove the taint of any prior transfers.

2. Where the transfer is to a partner of the insured. For instance, assume that three individuals are partners in a general partnership. One partner owns a policy on another’s life. If the third partner purchases the policy, there has been a transfer for value; however, since the transferee is a partner of the insured, the proceeds will be received income tax-free, because of the “transfers to a partner of the insured” safe harbor.

This safe harbor will be effective only if the insured is in fact a partner in a partnership (or an LLC taxed as a partnership), if the transferee is also a legitimate partner in that partnership, and the partnership itself is recognized as such (preferably) under both state and federal law.

For purposes of this exception to the transfer for value rule, the reason for the life insurance transfer and the size of the transferee’s interest in the partnership are both essentially irrelevant (in Ltr. Rul. 9045004, the partner owned only a 1% interest). Consequently, the purchase or ownership or transfer of the insurance does not have to be related in any way to the partnership itself. So as long as the transferee is actually a partner of the insured at the time of the transfer, the safe harbor rule would be met.

There is no requirement that the transferee partner be an individual. For example, in Ltr. Rul. 9347016, an irrevocable trust was a partner with the insured in a previously established family limited partnership (“FLP”). A corporation owned a policy on the life of one of its shareholders and sold that policy to the irrevocable trust. The IRS held that the transaction fell within the safe harbor for transfers to a partner of the insured—even though (1) the trust had only recently been created, and (2) the FLP was not related to the purpose for which the insurance was purchased. As suggested above, neither the nature of the partnership nor its relationship to the transfer is important to obtaining the safe harbor. As long as the transferee is a partner of the insured at the time of the transfer, the safe harbor will be available. The protection of this safe harbor extends even to limited partners and even if those limited partners are trusts.

The term “partner” of the insured has been interpreted in letter rulings as including “member” in the context of whether an LLC would be treated as a partnership under the safe harbor for transfers to partners. Because the LLC was taxable as a partnership, the members were considered partners for purposes of the transfer for value safe harbor rules in those rulings.

Beware: Transfers of life insurance to co-shareholders of the insured are not covered per se by this—or any other—safe harbor! Accordingly, under present law, the same transfer that would result in income tax-free death proceeds collected by a partner of the insured would result in ordinary income to a co-shareholder-transferee-beneficiary at the insured’s death.

Also beware: Planners must examine not only the transfer for value rule implications of a policy transfer but also the potential dividend and estate tax implications of the transfer. For instance, suppose that a corporation transferred a policy on the life of a shareholder to his two co-shareholder sons, both bona fide partners in a legitimate partnership, in return for the policy’s cash value. Although the transaction would fall within the safe harbor for transfers to partners, the difference between the policy’s cash value and its FMV (interpolated terminal reserve plus unearned
3. Where the transfer is to a partnership in which the insured is a partner. In the situation directly above, if the policyowner had sold the policy to the partnership, there would have been a transfer for value, but it would have been excepted from the rule because the transfer was made to the insured’s partnership.

Beware: A partnership or LLC, in form only, with no purpose or function other than to avoid the transfer for value rule would likely not be respected for this purpose. The entity should have some business or investment purpose and “enterprise activity,” if it is to be recognized for this purpose. The IRS will not issue advance rulings on whether or not a partnership, LLC, or limited liability partnership will be treated as such for federal income tax purposes, nor will it rule on whether or not a transfer of life insurance does in fact fall within either of the partner or partnership safe harbor rules.

Accordingly, commentators are generally uncomfortable with a situation where “substantially all of the organization’s assets consist or will consist of life insurance on the lives of members”—in spite of a ruling that has been widely (but mistakenly in the view of many commentators) touted to mean that a “life insurance only” partnership would per se qualify under one of the two partnership safe harbors.

It may be helpful in establishing the bona fides of the partnership to show that the cash values of insurance owned by and payable to the partnership in question comprise less than 50% of the partnership’s assets and to specifically authorize the carrying on, investment, and re-investment of other businesses and investments. Prudent planners will accumulate evidence supporting the fact that the partnership has purposes beyond the mere ownership and management of life insurance contracts and is therefore a bona fide entity serving purposes that range beyond mere “investment in life insurance.”

4. Where the transfer is to a corporation in which the insured is either an officer or a shareholder. For instance, if an individually owned policy is transferred to the insured’s corporate employer to be used as keyperson coverage or to fund a redemption-type buy-sell agreement, the transfer for value rule would not apply—if the insured were an officer or a shareholder in the corporation—at the time of the transfer. There is no requirement that the transferor be an officer or shareholder, only that the insured be an officer or shareholder.
As is the case with transfers to partners or transfers to partnerships where the insured is a partner, here, there is no specific or minimum number of shares that must be held by the insured to come within this exception.39 But again, corporate arrangements or titles without any substance will not provide shelter from the transfer for value rule. If the insured is an officer or employee in name only, has no executive duties or authority, doesn’t in fact perform services, or isn’t actually an owner of the company’s stock, the IRS is likely to take the position that this exception doesn’t apply.

Beware: This safe harbor does not protect transfers to co-shareholders of the insured, nor transfers where the insured is merely a key employee, no matter how “key” if he or she is not an officer or shareholder. So it will provide no shelter for a transfer in which the insured is a member of the company’s board of directors, but is neither an officer or a shareholder.

5. Where the transfer is to a spouse or (if certain tests are met) ex-spouse of the insured. For instance, if a husband transfers insurance on his life to his wife or former wife, in both cases a safe harbor exception to the transfer for value rule will be met.40 This favorable result occurs because of Section 1041, which provides that no gain or loss is recognized on the transfer, or even on the sale, of property between spouses. For income tax purposes, the transfer is treated as a gift. That means carryover basis rules apply to exempt life insurance transfers between spouses (and in many cases between ex-spouses) from the threat of the transfer for value rule.

Exhibit 2 summarizes the transfer for value rule safe harbors.

Amount excludable under ‘last transferor’ rule

When a policy is transferred by gift, the income tax-free death proceeds are limited to the sum of (1) the amount that would have been excludable by the party making the transfer had no transfer taken place, plus (2) any premiums and other amounts paid after the transfer by the transferee.41 For example, assume that an individual applied for and named herself as owner of a $1 million policy on the life of her husband, and then made an absolute assignment of the policy to her son, as a gift (i.e., for “love and affection”). Because the policy was transferred gratuitously, the maximum tax-free amount that the son could receive is $1 million (the same amount the transferor, his mother, could have received tax-free had the transfer not taken place) plus any premiums and other amounts (such as repayment of policy loans) he paid after the transfer.

What if the last transfer prior to the insured’s death was by gift, but there were other transfers prior to that for value? As noted above, the taint remains, unless the final transfer is to one of the safe harbor exempt parties, which would remove it. For example, where the last owner’s basis is determined in whole or in part by reference to the prior owner’s basis, the income tax exclusion is limited to the sum of (1) the amount that the transferor could have excluded had no transfer taken place plus, (2) any premiums or other amounts paid by the final transferee.

The typical result of a “series of transfers”42 is, if the last transfer is:

1. for valuable consideration, only the actual consideration paid by that transferee (plus premiums or other amounts paid after the transfer) is excludable. For example, if an insured purchases a $500,000 policy on his own life from a third party and gives it to his daughter, and she later sells it to the insured’s son, the son must report the entire $500,000 (less the amount he paid for the policy and any premiums he later paid) as ordinary income when his father dies;

2. a gift (or part sale and part gift), where the donee’s basis is determined at least in part by reference to the donor’s basis (which is not always the case in a part sale/part gift situation), the final transferee will be able to exclude the entire proceeds. Where an insured gives the policy to his daughter who gives it to her mother, the mother’s basis is determined by a carryover of the daughter’s basis, which in turn is carried over from (and therefore determined by reference to) the insured’s basis. The same result would occur if the daughter had sold the policy to her mother for a

39 Ltr. Rul. 9054004. Similarly, it is irrelevant whether the corporation is closely held or is a public company.
40 This protection applies only to post-7/18/84 transfers (or transfers made after 1983 if both spouses so elect) to U.S. citizen spouses. Transfers are considered “incident to a divorce” only if the transfer is made within a year after the termination of the marriage or is related to the end of the marriage. See Temp. Reg. 1.1041-1T(b), Q&A-6 and Q&A-7.
41 Reg. 1.101-1(b)(2). In either case, however, where the transfer is made to one of the “proper party” individuals or entities described in Section 101(a)(2)(B), the entire proceeds will be excludable from the transferee’s income.
42 The effect of a series of transfers for a valuable consideration of a life insurance policy or an interest therein is addressed in Reg. 1.101-1(b)(3)(ii), which indicates that if the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee can exclude from income the entire life insurance proceeds paid by reason of the death of the insured under Section 101(a)(1).
nominal price that resulted in more of a gift than a sale;\textsuperscript{43} or

3. to one of the five “proper parties,” that exempt transferee will be able to exclude the entire amount of the proceeds from income. If the insured had given a policy on his life to his daughter, and she had sold it to the insured’s son, who then sold it to a corporation in which the insured was a shareholder or officer, the corporation would receive the proceeds income tax-free.

Can the last transferor rule be avoided by “washing” an otherwise tainted transaction through a brief ownership by the insured? In other words, can the transfer for value tax trap be avoided by having the insured buy the policy and then make an immediate gift to the intended eventual owner? For example, in Ltr. Rul. 8906034, a corporation owned a policy on the life of an individual who owned 75\% of the firm’s stock. Four percent of the stock of that corporation was owned by the insured’s son who worked in the business, and the balance of the stock was owned equally by the five other children of the insured, none of whom worked in the family business. The insurance was briefly transferred to the insured who paid the corporation an amount equal to the policy’s value on the date of the transfer. The insured then made a gift of the policy to his son; at the same time the son promised to keep the insurance in force and use policy proceeds to buy his father’s stock when he died and to pay his father’s estate notes if there was a shortfall between the purchase price and the amount of insurance proceeds received.

The IRS ruled that this final transfer was a transfer for value and noted that in this case because the transfer was by gift, the transferee must determine basis by reference to the transferor’s basis. The rule is that the transferee can exclude from income the amount of proceeds that the transferor could have excluded had no transfer taken place. Of course, this meant the son could exclude the entire amount of the death proceeds, since a transfer to the insured is never taxable under the transfer for value rule.

\textbf{Beware:} Potential problems lurk even in a seemingly clear “safe” situation, such as the one above. The IRS could argue that the two transactions are in reality one—i.e., the step transaction doctrine should be used to collapse the parts into a single transfer from the corporation to the co-shareholder son. Moreover, the conclusion in the letter ruling regarding the tax-free receipt of proceeds was conditioned on the fact that the transfer from father to son was a gift. But what if the IRS argued that the real motivation for the father’s transfer was not merely love and affection, but rather to assure estate liquidity by creating a market for the father’s stock, or was in exchange for the son’s promise to pay premiums and buy back the stock?\textsuperscript{44} Perhaps in some situations, the IRS will assert that there was a quid pro quo, that each shareholder made a promise to buy the policy on his or her own life and then give it away in return for the other’s promise to do the same.

\textbf{‘Transfer’ and ‘valuable consideration’}

Two issues that must be resolved in every transfer for value case are: (1) has there been a “transfer” of a policy or an interest in a policy and, if so, (2) was there “valuable consideration” for that transfer?\textsuperscript{45} Obviously, these questions can’t be answered without a definition of the word “transfer” and the phrase “valuable consideration.”

There is no definition of the term “transfer for valuable consideration” in the Code. The income tax Regulations provide that such a transfer occurs whenever any absolute transfer for value of a right to receive all or any part of the proceeds of a life insurance policy takes place.\textsuperscript{46} This includes the creation for value of an enforceable right to receive all or any part of the proceeds of a policy, but excludes any pledge or assignment of a policy as collateral security.\textsuperscript{47} The creation by separate contract or agreement of a right to receive all or a portion of the policy proceeds would be considered a transfer for this purpose.

In Ltr. Rul. 9852041, the taxpayer and his brother were joint owners of life insurance policies. For administrative convenience and to allow the brothers to make decisions regarding their respective investments in the policies separately, they wanted to change the current joint ownership of the policies. The insurance companies will issue two separate policies, one owned by the taxpayer and the other owned by his brother, to replace each of the present policies. Each of the new separate policies will insure the same life as one of the policies and will provide one-half of the death benefit, cash value, and indebtedness. Each brother will pay equally, using his own funds, a nominal administrative fee to the insurance companies for the proposed

\textsuperscript{43} If the “sale” portion is greater than the “gift” portion of the transaction, the mother’s basis would be determined by the amount she had paid, rather than by reference to her daughter’s basis. That would mean the “transferor’s basis” exception to the transfer for value rule would not apply.

\textsuperscript{44} Those promises would be “consideration,” as discussed below; see the text at note 53, infra.

\textsuperscript{45} See Ltr. Rul. 199940028.

\textsuperscript{46} See Reg. 1.101-1(b)(4).

\textsuperscript{47} Id.
policy split. The IRS determined that in this situation, there was no transfer for transfer for value purposes.

If a transaction is deemed to be a nontaxable event, the requisite transfer may not be present. For instance, in Ltr. Rul. 200228019, there was a grantor-trust-to-grantor trust transfer of life insurance. The second trust purchased the policy owned by the first trust for its gift tax value, so clearly, there was consideration. But because both trusts were grantor trusts from the point of view of the same grantor, it was as if there was no policy transfer; it was disregarded for income tax purposes.

It is essential to note that under the broad scope of the definition found in the Regulations, a transfer for value occurs if, in exchange for any kind of valuable consideration, a policy beneficiary of all or any portion of the proceeds is named or changed. The rule applies even if there is no legal assignment of the policy, even though the policy has no cash surrender value at the time of the transfer, and even if the policy is term insurance (so that it never had and never will have any cash value).

Even though the transfer is found to be for a valuable consideration and none of the exemptions in Section 101(a)(2) to the transfer for value rule apply, if the consideration paid for the transfer plus any amounts paid subsequent to the transfer by the transferee exceed the proceeds of the policy, the entire amount of the proceeds will be excludable from income. Reciprocity as consideration. It is not necessary that the consideration given to support a transfer be in the form of cash or other property with an ascertainable value. No purchase price need be paid nor need money change hands; reciprocal promises and quid pro quos are treated as consideration. The “valuable consideration” requirement is met by any consideration sufficient to support an enforceable contract right. For example, in Monroe v. Patterson and Ltr. Rul. 7734048, the mutuality of shareholders’ agreements to purchase the others’ stock in the event of death was held to be enough consideration to invoke the transfer for value rule. Relief from loan liability as consideration. The IRS has even taken the position that a transfer of a life insurance policy subject to a loan was a transfer of the policy for value (at least to the extent of the loan). Presumably, the rationale is that the policyowner transferred the policy in consideration of being relieved of an obligation to pay an amount equal to the loan (although the nature of life insurance policy loans would seem to rebut this argument, and most commentators feel the IRS is overreaching in this argument).

If the transferor had an adjusted basis in the contract at least equal to or greater than the amount of the loan, the transferee would determine his or her basis at least in part by a carryover of the transferor’s basis. On the other hand, if the loan exceeds the transferor’s basis, the transferee may not carry over all or any portion of the transferor’s basis, and this would take the transaction out of the “transferor’s basis” safe harbor exception. The solution would be to pay off at least a portion of the loan prior to the transfer or to deliberately structure the loan so that it would not exceed the transferor’s basis at the time of transfer.

Nominal consideration. If the promise made in exchange for the transfer of the policy is nominal (e.g., “for one dollar”) or if in fact no consideration is ever paid (e.g., a father transfers a $5 million policy on his life to his daughter in return for her agreed payment to him of $1,000 which she never makes and he never demands), the fact that the assignment document states that a transfer of a policy (or an interest in a policy) and valuable consideration or to deliberately structure the loan so that it would not exceed the transferor’s basis at the time of transfer.

Conclusion

Generally, life insurance death proceeds are received income tax-free. However, if there has been both a transfer of a policy (or an interest in a policy) and valuable consideration (of any kind) given in exchange for that transfer, the exclusion may be lost. There can be a “transfer” even if the policy itself is not physically transferred or assigned; a separate

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48 For instance, consideration may be found for a transfer of life insurance in an employee’s implied promise to continuing working for the business.
49 See Lit. Rul. 9701026, in which shareholders wanted to have their corporation transfer existing split-dollar coverage to a trusteed cross-purchase plan to fund a buy-sell arrangement. The IRS ruled that the absolute transfer of a right to receive at least a portion of the policy proceeds (split-dollar financing was used) provided the requisite transfer and the corporation’s release from the obligation to pay premiums was sufficient valuable consideration to trigger the transfer for value rule.
50 See Reg. 1.101-1(b).
51 See, e.g., Desks, Inc., 18 TC 674 (1952), and Lambeth, 38 BTA 351 (1938). See also Haverty Realty & Investment Co., 3 TC 161 (1944), for a discussion of the valuable consideration issue where the insurance transfer documents and corporate minutes reflected the fact that the transfer was for valuable consideration.
52 Lit. Rul. 9701026.
55 See the discussion of policy basis, in the text at note 14, supra.
56 Haverty Realty & Investment Company, supra, note 51.
and enforceable contract or agreement transferring the right to receive all or a portion of the proceeds would suffice to bring a transaction within the transfer for value rule. On the other hand, pledging a policy as collateral will not be considered a transfer for this purpose.

For a recipient of life insurance death proceeds, if there has been a transfer for value of the policy, the excludable amount must be determined. The amount excludable from the gross income of the transferee-beneficiary is limited to (1) the consideration paid, plus (2) any premiums or other amounts paid subsequent to the transfer by the transferee. If the last policy transfer was gratuitous, the amount excludable by the transferee is (1) the amount that would have been excludable by the transferor had no transfer taken place, plus (2) any premiums or other amounts paid after the transfer by the transferee.

If there had been a transfer for value, but the transferee determined the basis in the policy in whole or in part by referring to the basis of the policy in the hands of the transferor, the entire proceeds are excludable—unless there has been a series of transfers—in which case, the final transferee can exclude (1) what the transferor could have excluded had no transfer taken place, plus (2) any premiums or other amounts paid by the final transferee. If the final transfer in a series of transfers is for valuable consideration, the proceeds are taxable except for (1) the consideration paid for the policy by the final transferee, and (2) the premiums or other amounts paid after the transfer. If the transfer (or if at least the final transfer) is to a “proper party” (the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer), the entire proceeds can be excluded.

Part 2 of this article, which will appear in the next issue of ESTATE PLANNING, will provide practitioners with warnings, guidelines, and practical solutions, organizing the issues raised by the application of the transfer for value rule along transactional lines. The discussion will analyze common situations facing practitioners in the areas of (1) buy-sell planning, (2) retirement planning, (3) general business planning, and (4) personal (including marriage dissolution) planning.

There is no de minimis rule exempting small transfers from the transfer for value rule.

The ‘transferor’s (carryover) basis’ exception applies only if the transferor held an otherwise untainted policy for transfer for value purposes.

Transfers of life insurance for value to co-shareholders of the insured are not covered per se by any safe harbor exception to the transfer for value rule.

A partnership or LLC, in form only, with no purpose or function other than to avoid the transfer for value rule will likely not be respected for this purpose.

PRACTICE NOTES

If an individually owned policy is transferred to the insured’s corporate employer to be used as keyperson coverage or to fund a redemption-type buy-sell agreement, the transfer for value rule would not apply—if the insured were an officer or a shareholder in the corporation—at the time of the transfer.

Exhibit 1

<table>
<thead>
<tr>
<th>Amount</th>
<th>Loss if Single</th>
<th>Loss if Joint</th>
<th>Loss if Trust</th>
<th>Loss if C Corp</th>
<th>Loss if Service Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable</td>
<td>$100,000</td>
<td>$19,415</td>
<td>$14,230</td>
<td>$34,107</td>
<td>$22,250</td>
</tr>
<tr>
<td>$500,000</td>
<td>153,720</td>
<td>145,563</td>
<td>174,107</td>
<td>170,000</td>
<td>175,000</td>
</tr>
<tr>
<td>1,000,000</td>
<td>328,720</td>
<td>320,563</td>
<td>349,107</td>
<td>340,000</td>
<td>350,000</td>
</tr>
<tr>
<td>5,000,000</td>
<td>1,728,720</td>
<td>1,720,562</td>
<td>1,749,107</td>
<td>1,700,000</td>
<td>1,750,000</td>
</tr>
</tbody>
</table>

Exhibit 2

<p>| Transferee for Value | Insured | Partner of insured | Tax Result | OK | OK |</p>
<table>
<thead>
<tr>
<th>Description</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership in which insured is a partner</td>
<td>OK</td>
</tr>
<tr>
<td>Corporation in which insured is a shareholder or officer</td>
<td>OK</td>
</tr>
<tr>
<td>Anyone where basis is determined in whole or in part by reference to transferor’s basis</td>
<td>OK</td>
</tr>
<tr>
<td>Co-stockholder of insured</td>
<td>Not OK,</td>
</tr>
<tr>
<td></td>
<td>unless</td>
</tr>
<tr>
<td></td>
<td>basis</td>
</tr>
<tr>
<td></td>
<td>carryover applies</td>
</tr>
<tr>
<td>Spouse or ex-spouse (if pursuant to divorce and meets Section 1041 tests) of insured</td>
<td>OK</td>
</tr>
<tr>
<td>Anyone else or any other entity</td>
<td>Not OK,</td>
</tr>
<tr>
<td></td>
<td>unless</td>
</tr>
<tr>
<td></td>
<td>basis</td>
</tr>
<tr>
<td></td>
<td>carryover applies</td>
</tr>
</tbody>
</table>