

# Taxation of Life Insurance: Understand the Issues to Avoid Mistakes

By *Pettus C. (“Pete”) Gibbons*

Pete Gibbons discusses crucial issues that arise in planning with life insurance.

Working with a client’s estate plan almost always involves life insurance. Life insurance may fulfill a number of functions for your clients; among them are estate creation, estate conservation and estate distribution. Many of your clients either have insurance on their lives or are contemplating a purchase of life insurance as part of the planning process. Frequently, when the client or their business already owns life insurance, the history of the existing life insurance policies are ignored (original purpose, transfers of ownership, change of beneficiaries, loans, *etc.*). There may be many reasons for insurance purchases and changes. You must know how to recognize the tax and planning issues that may be applicable. Estate planning is a dynamic process involving many variables. A small change in one variable of the planning can have a significant impact on the estate plan. Another reason to review these policies is to understand them in light of changing tax laws and other legislation.

Not all clients need complex wills, trusts, Family Limited Partnerships (FLPs), Intentionally Defective Irrevocable trusts (IDITs), *etc.* As a matter of fact, most clients need only basic legal work and documents in their planning. Your client’s life insurance must be structured properly, including consideration and planning for ownership at the inception of the policy. After the policy is issued, care must be taken as many changes may create significant tax and other issues. In the following case studies, we will identify issues that arise in planning with life insurance.

**Pettus C. Gibbons**, MEd, CLU, ChFC, LUTCF, AEP AVP, The Natalus Group, Advanced Sales Consultant, New York Life Insurance Company. He is currently a board member for the National Association of Estate Planners & Councils. You may reach Mr. Gibbons at [Pgibbons@newyorklife.com](mailto:Pgibbons@newyorklife.com).

## *Case 1—No Gift Tax Gift of Life Insurance?*

Your client has a policy for which he has paid \$50,000 in premiums. The policy has a total cash value of \$85,000. The client wants to give the policy to his son but does not want to have a taxable gift. He decides that he will borrow \$61,000 of the cash value. The remaining (net) cash value would be \$24,000. A gift of a policy with a \$24,000 net cash value can qualify for the gift tax annual exclusion if both the client and his spouse make the gift (or if the husband and wife join in gift splitting). In the coming years he plans on gifting the rest of the cash value to the son so the son can pay off the policy loan.

**Issues Case 1.** When a policy is gifted with a loan that exceeds basis, the forgiveness of the loan in excess of the basis in the contract will create a transfer for value.<sup>1</sup> (See “Transfer for Value.”)

## *Case 2—Janitor Insurance*

Your client owns a business that has a number of nonowner key employees. The business purchases a key employee policy on one of them this year. The key employee retires in 10 years and dies two years later; the employer had retained the policy. While the employee was a key employee she was not a highly compensated employee (HCE). What are the tax consequences to the business?

**Issues Case 2.** The new Code Sec. 101(j) general rule is that the death benefit proceeds from employer-owned life insurance is income taxable to the employer to the extent it exceeds the premiums paid for the policy. This is true where the policy does not meet the notice and consent and other requirements. (See “Employer-Owned Life Insurance.”)

©2007 P.C. Gibbons

### ***Case 3—All in One, Key Executive and Personal Protection***

Your client is a stockholder in a C corporation. He has a key employee that is extremely important to the business. Your client has determined that he needs at least \$500,000 of life insurance to indemnify the business should the key person die. The key employee also has expressed a desire to have \$250,000 of insurance payable to his wife to help her with finances should he die. The corporation has purchased a \$750,000 life insurance policy with \$500,000 payable to the corporation and \$250,000 payable to the key employee's spouse.

**Issues Case 3.** Assuming the requirements of Code Sec. 101(j) are met, the \$500,000 payable to the corporation is income tax free to the corporation,<sup>2</sup> and can be used to help indemnify the corporation from the loss of the key employee. The \$250,000 payable to the key employee's family will be taxable as income. This

situation could have been solved with the purchase of two policies, the \$500,000 life policy owned by the corporation and a \$250,000 policy owned either by the insured or as part of a split-dollar arrangement. If the \$250,000 policy is owned by the employee, the corporation can take a deduction for the premium paid (provided it is reasonable compensation) and the key employee would have to pay the income tax on the amount of the premium. With the split-dollar plan, the corporation would own the policy and endorse the right to name the beneficiary to the employee. The employee would pay tax on an economic benefit each year.<sup>3</sup> The cash value would be owned by the corporation and the balance of the death benefit (total death benefit minus the interest of the corporation) would be payable to the employee's beneficiaries.

### ***Case 4—Dad, Mom and the Kids***

Your client and his wife amassed a \$6 million estate and were concerned about estate taxes. They knew that if the wife owned the life insurance policies on the husband's life, there would be no estate taxation of the proceeds at his death. The wife named her three children, ages 12, 15 and 18, as equal beneficiaries of the \$1.5 million life insurance policy. The husband died earlier this year.

**Issues Case 4.** There are a number of issues in this case. First, the client was right that ownership of the policy by his wife would exclude the death benefit from taxation in his estate. The error of this decision was that the designation of the children as the beneficiaries created a gift tax issue for the wife. At the husband's death, the wife is deemed to have made a taxable gift to her three children in the amount of \$500,000 each. This will create a total gift tax of \$540,320 (total gifts to children \$1.5 million minus \$12,000 annual gift tax exclusion for each child equals a taxable gift of \$1,464,000). After the lifetime unified credit of \$345,800, she will have gift taxes payable of \$194,520.<sup>4</sup> The final issue is that two of the children are minors and the oldest, age 18, just

reached majority. Before the insurance company will pay the death benefit, they will petition the court for a determination of what should be done with the death benefit proceeds for the minor children. The court may

have to determine how the cash for each of the minors would be held. The court could either direct that the proceeds be held under the court supervised guardianship account, a Uniform Gift to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA) account, or paid to the mother to hold for the children until each child reaches majority. In any case, the children will have access to the cash at their majority. We should always be concerned when children have unfettered access to that much money at such a young age. All of this could have been eliminated with an irrevocable life insurance trust, and proper will and trust planning.

### ***Case 5—"Parting Gift" Life Insurance Policy***

A corporation has owned a key man policy funded with permanent insurance. The key employee is nearing retirement. The corporation paid \$95,000 for the policy over the years. The current cash value of the policy is \$200,000. The majority owner of the corporation wants to give the policy to the key employee as a "parting gift." What, if any, consequences are there to the corporation and the employee?

**Issues Case 5.** The corporation can transfer the policy to the key person. The transfer is a taxable event to the employee, where the employee will have

Your client's life insurance must be structured properly, including consideration and planning for ownership at the inception of the policy.

taxable income of \$200,000. The corporation will have taxable income of \$105,000 and an income tax deduction (provided it is reasonable compensation) of \$200,000 for the distribution to the employee.<sup>5</sup> If the employer and employee are willing to work together, the corporation can sell the policy to the employee on an installment basis. Annually, the business can forgive that year's debt. By doing this, you can spread out both the taxable income to the executive, and the taxable income and income tax deduction to the corporation.

In this case, we valued the policy simplistically at its cash value. Recently, the IRS has provided safe harbor guidelines on how to determine the fair market value of a life insurance policy. The fair market of a business-owned life insurance policy may be the greater of the following: the interpolated terminal reserve and any unearned premiums, plus a *pro rata* portion of expected dividends for that year; or the PERC amount. "PERC" stands for a valuation formula that takes into account the Premiums paid, Earnings from the cash in the contract and Reasonable Charges for mortality and policy expenses.<sup>6</sup>

### ***Case 6—Cash It in and Buy New***

The client has a life insurance policy with over \$200,000 of cash value. His basis is \$50,000 but the face amount is only \$300,000. Also, the insurance company has very poor financial ratings and is having significant financial difficulties. An agent recommends the client cash in that policy and purchase a new policy from his company with a death benefit of five times the current policy with the same premium. The client thinks this is a great deal and goes through with the transaction.

**Issues Case 6.** The agent should have recommended a Code Sec. 1035 exchange. The transaction above will create an income tax on the \$150,000 gain in the policy.<sup>7</sup> The client will then only have the balance after tax to put toward the new policy. With a Code Sec. 1035 exchange, the client would have been able to transfer the entire \$200,000 to the new policy and maintain the \$50,000 basis in the new plan. (See "Code Sec. 1035 Explanation.")

### ***Case 7—Government Life Insurance***

Your client has some government life insurance. Is it taxed differently than other policies?

**Issues Case 7.** Like most life insurance, the entire death proceeds of a government life insurance policy are received income tax free. What is different is

that the surrender of the government life insurance policy or an endowment policy, regardless of gain, will not produce an income taxable event for the policy owner. Also, the interest portion of a lifetime income annuity generated by the death benefit is also income tax free.<sup>8</sup>

### ***Case 8—Fund That Trust!***

The client has a will previously drawn by their family attorney. The will has a trust that manages assets for the children and dictates which assets will be held until the youngest child reaches the age of 30. To make sure there is enough money in the trust, the client changes the beneficiary on his/her life insurance to his/her estate.

**Issues Case 8.** This is obviously a simple issue, but a common practice frequently recommended by the attorney drafting the will. When a life insurance policy is payable to the estate of the insured, it is included in the taxable and probate estate of the insured at death. Of course, any incident of ownership will cause life insurance inclusion in the taxable estate of the insured, but in this case there are other issues. All assets in the estate are subject to probate, so in this case the life insurance may generate additional probate costs. Also, all assets in the estate are generally a matter of public record and many estate owners want to keep as much privacy as possible. Last, but certainly not least, the proceeds of the life insurance policy are needlessly subjected to the claims of the estate owner's creditors in many states and thus may not be available to fund the trust as planned.

### ***Case 9—Kids Own***

Your clients have parents with a large estate. The parents see the need for life insurance to pay estate taxes, and the need for this insurance to be owned in such a way that the proceeds will not be included in the taxable estate for either of them. While the parents do not mind joining together to pay the \$66,000 premium for the life insurance, they are not interested in dealing with all of the details and legal work of an irrevocable life insurance trust. The agent suggests that the three children own the policy jointly and that the parents pay the premium to the life insurance company.

**Issues Case 9.** While this tactic may well keep the death benefit out of the estate, there are gift tax issues. When the premiums are paid to the life insurance company, there is no present use and enjoyment (present interest)<sup>9</sup> in the \$66,000 by the children, (present use

and enjoyment is a requirement to meet the qualifications for an annual exclusion gift). Even if the policy had adequate cash value to meet the possible cash demands of \$66,000 from the three children, there is no way for the money to be withdrawn without the agreement by all three owners (therefore no gift of present interest and no annual gift tax exclusion). In this case the parents would lose \$66,000 of their lifetime exclusion each year (and would have to file an annual gift tax return). This idea could work if each of the parents made cash gifts to each of the children of \$24,000.<sup>10</sup> The children would then have to write their checks to the insurance company to pay the life insurance premium. With a properly drawn and administered irrevocable life insurance trust with *Crummey* provisions, the \$12,000 annual exclusion gifts<sup>11</sup> (up to \$24,000 either if each parent gifts \$12,000 for each *Crummey* beneficiary, or if the parents gift split) would qualify as a present interest gift and thus the annual gift tax exclusion.

### ***Case 10—And Have His Cake Too***

Your client wants to buy a life insurance policy and make it payable to his college alumni fund. He is expecting an income tax deduction for the premium paid. He also expects to be able to use the cash value of the policy.

**Issues Case 10.** Your client can own the policy, and therefore is able to retain all ownership rights including access to the cash value and the ability to change the beneficiary. If this is the case, however, your client will not be able to deduct the premiums on the policy despite a charitable beneficiary. Because the client owns the policy, it will be included in his estate. The estate, however, will get an estate tax charitable deduction for the amount paid to the charity.<sup>12</sup> What if instead, the client makes the charity the owner and beneficiary of the policy and simply pays the premiums? Subject to the overall limit on charitable deductions, the client will be able to deduct all of the premiums he pays to the insurance company on the policy owned by the charity.

### ***Case 11—Give the Old Policy***

Your client has an existing life insurance policy that she no longer needs. She is considering giving the

policy to her church. The policy is eleven years old and she has paid premiums of \$5,000 per year. The policy has an Interpolated terminal reserve (usually the same or similar to the policy cash value) of \$100,000. What are the tax ramifications of gifting the policy to the charity?

**Issues Case 11.** If your client gives this policy to her church, she will have to reduce her charitable deduction by the \$45,000 gain in the policy. Had the client surrendered the policy, she would have had to recognize the \$45,000 gain as ordinary income.<sup>13</sup> The deduction for the life insurance policy given to the charity is limited to the lesser of basis<sup>14</sup> in the contract or the policy's interpolated terminal reserve.<sup>15</sup>

### ***Case 12—Trust First ... Insurance Next!***

Your client wants a \$1 million life insurance policy. The policy is to be owned by an irrevocable life insurance trust (ILIT) to keep it out of his estate. The agent sells the policy to the insured (the insured is the owner of the policy) using an automatic monthly check withdrawal from the client's checking account. The agent then makes sure the client gets to an

attorney to set up the ILIT. Several months later, the ownership of the policy is changed to the trust. The automatic monthly check withdrawal is continued as the payment method.

**Issues Case 12.** First, if a new policy is to be owned by an ILIT, the original applicant, owner, premium payer and beneficiary should be the trustee of the ILIT. In our case, the policy is gifted to the ILIT after it has been issued. This transaction would fall within the three-year contemplation of death rule<sup>16</sup>. Interestingly enough, there appears to be a solution for this situation. If the ILIT is a grantor trust<sup>17</sup> and the policy is on the life of the grantor, the grantor can make a cash gift to the trust so that the ILIT can purchase the policy from the grantor. Since a grantor trust, for income tax purposes, is considered owned by the grantor, the sale of the policy to the trust is like a sale of the policy to himself. A sale of a policy to the insured is an exception to the transfer for value rule.<sup>18</sup> (See "Transfer for Value Rules.")

New Code Sec. 101(j) defines an employer-owned policy as a life insurance policy owned by a person engaged in a trade or business where the person owning the policy ("applicable policyholder") is also a direct or indirect beneficiary under the policy.

It is also important to note that using the automatic monthly check withdrawals will not work with an ILIT, at least in the early years, because of the necessity of timely *Crummey* letters and the availability of funds to pay any demand for cash. A cash gift is typically made to the trust in an amount that approximates the annual premium, the *Crummey* letters are notices giving the beneficiaries a period of time to claim the cash mentioned in the letter. After the time period for claim in the *Crummey* letter ends, the money is paid as a premium for the policy in the ILIT.

### ***Case 13—“Phantom Income” from a Life Policy***

Your client has purchased a life insurance policy that is designed as a supplemental life insurance retirement plan (SLIRP). Under this type of plan, a larger than minimum premium is paid into the life insurance policy and at some time in the future, the client can take withdrawals and loans for cash flow or other needs without income taxes at the time of the withdrawal. In this situation, the policy was illustrated showing a \$100,000 withdrawal/loan each year for ten years and a death benefit for the balance of the insured's life. As is sometimes the case, the client took the \$100,000 distribution (loan) for an extra two years for total withdrawals of \$1.2 million. The client paid \$550,000 for the policy. Because of the additional withdrawals, the policy lapsed five years later.

**Issues Case 13.** When the policy lapses, the client will have income of \$1.2 million plus interest on any loans, offset by the cost basis of \$550,000. Generally, a loan taken from a life insurance policy (that is not classified as a MEC) is not includable in the policy holder's income at the time of the loan because it is not treated as a taxable distribution.<sup>19</sup> If a loan is outstanding when the policy lapses (or is surrendered) the gain in the contract (excess of total cash value over the basis in the policy) is taxable as if they had actually received the cash in the transaction.<sup>20</sup> Any policy loan outstanding at the date of death generally reduces the death benefit in the contract.

### ***Case 14—Leveraging the Credit Shelter Trust***

Husband and Wife have a \$6 million estate. The husband died this year with a tax-wise will that created a credit shelter trust funded with \$2 million cash. The wife is the trustee of the credit shelter trust. The wife did not feel she would need any of the income or principal of the credit shelter trust and asked for ideas of how the money in the trust might best be invested.

Her life insurance agent suggested a single premium life insurance policy as a good way to leverage the trust on an income tax-free basis.

**Issues Case 14.** Before this transaction can be completed, the terms of the credit shelter trust must be reviewed to determine if the trustee has the right to purchase life insurance in the trust. Care must also be taken to make sure the life insurance policy will not be included in the wife's estate because, as trustee, she has too much access and discretion over the trust. If this is the case, she may be able to add a co-trustee, or resign her position in favor of a successor trustee.

The purchase of a single premium life insurance policy creates a modified endowment contract (MEC).<sup>21</sup> If the beneficiaries of the credit shelter trust need any cash from the trust prior to the mother's death, the money would be income taxable to the extent of any cash value that is in excess of the single premium paid. The 10-percent penalty will also most likely apply since the trust, as the owner/taxpayer, will never be age 59 1/2. A better strategy might be to purchase a single premium immediate annuity in the trust that will pay for a life insurance policy with a premium just under the amount that would create a MEC. Care must be taken with this strategy to make sure that there is adequate risk to the insurance company involved. When an individual buys a single premium lifetime only annuity and a life insurance policy from the same insurance company on the same life within a reasonable period of time, it has been found that the insurance company actually had no risk.<sup>22</sup>

### **Code Sec. 1035 Explanation**

Code Sec. 1035 allows for certain tax free exchanges of life insurance policies, endowment policies and annuities. The main purpose of this code section is to either shelter gain on the exchange, or preserve the basis of the old contract. For the exchange to qualify the new policy must have the same insured(s)/annuitant(s) after the exchange as the policy did before the exchange. Under this code section, a life policy can be exchanged for another life insurance policy, an endowment, or an annuity. An endowment can be exchanged for another endowment (with an endowment date no later than the current endowment date) or an annuity. An annuity can only be exchanged for another annuity.<sup>23</sup> Additionally, starting in 2009, under the

Pension Protection Act of 2006,<sup>24</sup> all life policies and annuities can be exchanged tax free for a long term care policy.<sup>25</sup>

If a policy has a loan and is the subject of a Code Sec. 1035 exchange, the loan will be taxable to the owner to the extent that there is gain in the policy. If the policy with the loan is Code Sec. 1035 exchanged for another policy with an equal loan, gain in the policy will not have to be recognized as part of the exchange.<sup>26</sup> The basis of the new policy immediately after the exchange will be the basis of the old policy plus the amount recognized as gain, minus any cash benefit received in the exchange (including forgiveness of debt in the policy). It is important to note that a life policy on a single life can not be exchanged for a last-to-die survivorship policy. A couple with an individual life policy on each of them cannot make a Code Sec. 1035 exchange for a survivorship policy.<sup>27</sup> A couple with a last-to-die survivorship policy can not exchange it for an individual policy or even an individual life insurance policy on each of them. Interestingly enough, the IRS has approved an exchange of a last to die policy after the death of the first insured for an individual policy on the life of the survivor.<sup>28</sup> Also, a Code Sec. 1035 exchange is not available to individuals who are not citizens of the United States.<sup>29</sup>

## Employer-Owned Life Insurance

On August 17, 2006, President Bush signed the Pension Protection Act of 2006, which, among other things, added a new section to the Internal Revenue Code—Code Sec. 101(j)—that codifies life insurance industry “best practices” relating to the use of employer-owned life insurance. Under Code Sec. 101(j), the new general rule (which is an exception to the basic rule under Code Sec. 101(a)) is that life insurance death benefits received by an employer from an employer-owned life insurance policy on the life of an employee will be included in the taxable income of the employer to the extent that the total death benefit exceeds the total premiums and other consideration paid for the policy. There are a number of exceptions to this rule.

New Code Sec. 101(j) defines an employer-owned policy as a life insurance policy owned by a person engaged in a trade or business where the person owning the policy (“applicable policyholder”) is also

a direct or indirect beneficiary under the policy. In order to meet the definition of “employer-owned,” the insured must also be an employee of the employer on the date the policy is issued.<sup>30</sup>

Employer owned policies include the following:

- Life insurance contracts owned by persons engaged in trade or business and under which such person is directly or indirectly a beneficiary under the contract
- Corporate-owned life insurance (COLI)
- Bank-owned life insurance (BOLI)
- Life insurance for:
  - Key persons
  - Buy and sell arrangements
  - Nonqualified deferred compensation funding
  - Endorsement split dollar
- Policies where the employer has partial ownership, which may include collateral assignment split dollar (including both loan regime and economic benefit regime)

Death benefits from employer-owned arrangements that satisfy the life insurance industry best practices will continue to be income tax exempt. In order for the exceptions to the general rule of Code Sec. 101(j) to apply, the “notice and consent requirements” must be met and one of the “exceptions” must apply. Policies meeting both the notice and consent requirements and the exception rules will exclude the full amount of death benefits from income taxation.

There are three elements to the notice and consent requirements, all of which must be satisfied before a new employer-owned life insurance policy is issued. The notice and consent form must be signed by the insured employee prior to the policy’s issue date. The three notice and consent requirements will be met if, before issuance of the policy, the employee:

1. is informed in writing that the applicable policyholder (employer) intends to insure the employee’s life and is informed in writing of the maximum face amount for which the employee could be insured at the time the contract is issued;
2. consents in writing to being insured under the policy and that such coverage may continue after termination of employment; and
3. is informed in writing that the employer will be a beneficiary of death benefits under the policy.

The term “employee” for the notice and consent requirements specifically includes officers, direc-

tors and highly compensated employees<sup>31</sup>. Potential insureds whose qualification is based on status as highly compensated individuals may be exempt from the notice and consent requirements.<sup>32</sup>

In addition to satisfying all three “notice and consent requirements” above, there are three exceptions to the income inclusion rule of employer-owned policy death benefits; one must apply in order to exclude death proceeds from income under this rule:

1. The insured was an employee at any time during the 12-month period before the insured’s death.
2. The insured, at the time the policy was issued, was a director, a “highly compensated employee” or a “highly-compensated individual.” This means that all of the following insureds under an employer-owned policy would qualify the policy for full income tax free death benefit treatment:
  - a. A director of the employer
  - b. A five-percent-or greater owner of the employer at any time during the preceding year
  - c. An employee who received compensation in excess of \$100,000 for 2007 (adjusted in the future for inflation)
  - d. An employee who is one of the five highest paid officers at the time the policy becomes effective
  - e. An employee who is among the highest paid 35 percent of all employees at the time the policy becomes effective
3. The amount received by reason of the insured’s death to the extent it is paid to:
  - a. A family member of the insured
  - b. A designated beneficiary of the insured (other than the policy owner-employer)
  - c. A trust established for a family member or designated beneficiary
  - d. The estate of the insured

These rules generally apply to employer-owned policies issued after August 17, 2006. Policies issued on or before August 17, 2006, are fully grandfathered, as are new policies issued as a result of a grandfathered policy being exchanged under Code Sec. 1035. However “any material increase in the death benefit” or other “material change” to the policies will cause the policy to be treated as a new policy subject to the rules and requirements of new Code Sec. 101(j).

## Transfer for Value Rules

The general rule for income taxation of a life insurance death benefit is that death benefits are income tax free to the beneficiary.<sup>33</sup> An exception to this rule is when a life insurance policy is transferred for valuable consideration. This exception typically requires that the death benefit in excess of the basis of the transferee will be income taxable at the death of the insured.<sup>34</sup> The basis in the hands of the transferee is the consideration given for the contract plus the premiums paid by the transferee after the transfer. There are five exceptions to the transfer for value rule:

1. A transfer to the insured<sup>35</sup>
2. A transfer to a partner of the insured (members of an LLC taxed as a partnership are considered as partners for purposes of this rule)<sup>36</sup>
3. A transfer to a partnership in which the insured is a partner (or an LLC taxed as a partnership where insured is a member)
4. A transfer to a corporation in which the insured is an officer or stockholder
5. If the basis for determining gain or loss in the hands of the transferee is determined in whole or in part by the basis of the transferor<sup>37</sup>

The transfer for value rules extend well beyond a simple purchase of a policy from an individual. Examples include the following:

- Two owners of a corporation, A and B, want a cross purchase buy-sell agreement, and to fund the plan they intend to trade life insurance policies. A is going to trade his policy to B and B is going to trade his policy to A.<sup>38</sup> The same would hold true if A made B the beneficiary of A’s policy and B made A the beneficiary of B’s policy. Also note that the same result occurs if the policies are term policies with no value.
- The transfer of a life insurance policy subject to a nonrecourse (policy) loan as a gift will discharge an obligation of the insured. If the loan is larger than the basis in the policy, then a transfer for value will occur.<sup>39</sup> If, however, the loan is less than the basis in the policy, the gift of the policy will be considered part sale and part gift, and will not create a transfer for value. The reason for this is that the basis in the hands of the transferee will be determined, at least in part by, the basis of the transferor.<sup>40</sup>
- A gift of a policy to the son with the condition that the son will pay the cash value amount to the parent will create a transfer for value.<sup>41</sup> A legitimate gift for no or minimal consideration given out of

love and affection will not be a transfer for value but will be characterized as a gift.

- In a corporation where there were two key employees that wanted to buy the business, the corporation transferred life insurance policies on the life of the owner to a trust. After the transfer to the trust the key employees paid the premiums due. The trust held the policies and used the proceeds to purchase the interest of the sole stockholder upon his death. The court held that this was a transfer for value even though it (the trust) never paid a price to the corporation to purchase the life insurance policies. The agreement to pay future premiums and their purchase agreement were considered the valuable consideration.<sup>42</sup>
- A transfer for value is created when an employer with a redemption buy-sell plan changes the plan to a cross purchase arrangement as part of the transaction. The corporation transfers the policy on stockholder A to stockholder B and then transfers the policy on stockholder B to stockholder A.<sup>43</sup> In this case, the valuable consideration could be relieving the corporation of future premiums, or in relieving the corporation of the obligation of redeeming the stock.
- When a cross purchase plan is between more than two owners of a corporation, the death of one of the stockholders may create a problem. For example, with three owners, stockholder A owns a policy on stockholders B and C. Stockholder B owns a policy on stockholders A and C. Stockholder C owns a policy on stockholders A and B. At the death of stockholder A, stockholder B and stock-

holder C collect the death benefit on stockholder A and purchase A's interest from his/her estate. Now A's estate owns a policy on stockholder B and stockholder C. Stockholder B wants the policy on stockholder C and *vice versa*. When stockholder B purchases the policy on the life of stockholder C, it is a transfer for value. This can be solved with a wait-and-see buy-sell arrangement and a transfer from the estate of A (in this example) to the corporation. The wait-and-see buy-sell allows for purchase of stock from the deceased stockholder's estate by either the surviving stockholders or by the entity. Note that if the business was a partnership or limited liability company (LLC), the various partners/members would be an exception to the transfer for value rule and therefore this scenario would not create an issue.

- A transfer of a policy by a corporation to a stockholder as part of a liquidation is considered a transfer for value unless it is transferred to an excepted party such as the insured.<sup>44</sup>

There are some notable situations where a transfer other than a gift is *not* considered a transfer for value:

- A transfer of a policy pursuant to a court decree or order to a spouse or former spouse incident to a divorce<sup>45</sup>
- The mere assignment of a life insurance policy as collateral for a loan<sup>46</sup>
- A transfer where the transferee receives no valuable consideration whatsoever<sup>47</sup>

It is important to note that if a transfer for value is discovered prior to the death of the insured, it can be corrected by a transfer of the policy to one of the excepted parties listed above.

## ENDNOTES

<sup>1</sup> Reg. §1.1001-2(a)

<sup>2</sup> A life insurance policy death benefit payable to a "C" corporation may be subject to corporate alternative minimum tax. Code Secs. 55-59. There is a small corporation exemption from the tax. To qualify for the exemption, the corporation's average annual gross receipts for the last three years must not exceed \$7.5 million. To qualify initially for the exemption, the rules are the same, but with \$5 million annual gross receipts. A corporation is generally exempt from corporate alternative minimum tax for the first year of the corporation's existence. Code Secs. 55(3), 448(c)(3).

<sup>3</sup> Notice 2002-8, 2002-1 CB 398.

<sup>4</sup> *A.F. Goodman*, CA-2, 46-1 USTC ¶10,275, 156 F2d 218 (1946).

<sup>5</sup> Code Sec. 83.

<sup>6</sup> Rev. Proc. 2005-25, IRB 2005-17, 962.

<sup>7</sup> Code Sec. 72(e)(1)(A); Code Sec. 61(a)(10) Gains from a sale, surrender, or lapse of a life insurance policy, during the life of the insured are ordinary income to the owner of the policy. All death proceeds are generally excluded from income Code Sec. 101(a).

<sup>8</sup> Code Sec. 5301(a); Rev. Rul. 71-306, 1971-2 CB 76.

<sup>9</sup> The gift of a future interest in property will not qualify for the annual exclusion. To qualify, the gift must be a gift of "present interest" Code Sec. 2503(b) rights to an insurance policy are considered a present interest if the donee has unfettered access to the policy. Reg. §25.2503-3(a) (1958).

<sup>10</sup> A husband and wife can join together to

make gifts. This enables them to make an annual exclusion gift to as many people as they wish of \$24,000 each annually in 2006 (indexed for inflation in the future). Code Sec. 2513; Reg. §25.2513-1. When a couple agrees to split gifts, they must split all gifts given to any donee during the tax year. Code Sec. 2513(a)(2).

<sup>11</sup> \$10,000 annual exclusion gifts indexed for inflation. The 2006 indexed amount is \$12,000. This amount will be adjusted for inflation and rounded down to the nearest \$1,000 the future due to indexing. Code Sec. 2503(b)

<sup>12</sup> Code Sec. 2042(2), 2055; *J.E. McKelvy*, CA-3, 36-1 USTC ¶9130, 82 F2d 395 (1936); *M.I. Pupin Est.*, CA-2, 39-2 USTC ¶9776, 107 F2d 745 (1939).

<sup>13</sup> Code Sec. 170(e)(1)(A).

<sup>14</sup> “Basis” or investment in the contract is generally the total premiums paid reduced by any amounts (excludable from income) previously received. Premiums for the contract, for the purpose of basis in the policy, would be the gross premium minus any consideration paid for supplementary benefits such as waiver of premium, accidental death benefit, etc. Rev. Rul. 55-349, 1955-1 CB 232; *Wong Wing Non Est.*, 18 TC 205, Dec. 18,949 (1952). Any unpaid policy loans must be subtracted from gross premiums to arrive at the true basis. Reg. §1.72-6. In the case of a participating policy, dividends paid in cash or used to reduce premiums will reduce the basis in the contract. If the contract has been purchased from another party, the basis will be the consideration paid for the policy plus any premiums paid by the purchaser for the policy after the purchase of the policy.

<sup>15</sup> *E.R. Behrend*, 23 BTA 1037, Dec. 7084 (1931).

<sup>16</sup> Code Sec. 2035.

<sup>17</sup> A grantor can retain certain interests in a trust that is created by him that will cause any income in the trust to be taxed to the grantor. Code Sec. 673 through Code Sec. 677.

<sup>18</sup> LTR 9041052 (July 17, 1990); LTR 9852041 (Sept. 29, 1998); Rev. Rul. 2007-13, IRB 2007-11, 684.

<sup>19</sup> Code Sec. 72(e)(5).

<sup>20</sup> *S.L. Atwood*, 77 TCM 1476, Dec. 53,268(M), TC Memo. 1999-61.

<sup>21</sup> A modified endowment contract is a policy that meets the requirements of Code Sec. 7702 with a policy date on

or after June 21, 1988, that fails to meet the seven-pay test. Code Sec. 7702(A)(1). Any withdrawal, loan, or assignment of a modified endowment will result in taxable income to the extent of gain in the life insurance policy. A dividend paid in cash will also be a taxable event. If a policy has a loan, and the loan interest is paid from policy cash values, then to the extent there is gain in the policy this will also create an income taxable event. To the extent a distribution of any kind is taxable, it may also be subject to the 10-percent penalty for withdrawals where the taxpayer is not age 59 1/2.

<sup>22</sup> *E. Le Gierse et al.*, S.Ct. 41-1 USTC ¶10,029, 312 US 531, 61 S.Ct 646 (1941).

<sup>23</sup> Code Sec. 1035(a).

<sup>24</sup> Pension Protection Act of 2006 (P.L. 109-222).

<sup>25</sup> Code Sec. 1035(a)(3), amended by P.L. 109-222.

<sup>26</sup> LTR 8806058 (Nov. 17, 1987) and LTR 8604033 (Oct. 25, 1985).

<sup>27</sup> LTR 9542037 (July 21, 1995).

<sup>28</sup> LTR 9248013 (Aug. 28, 1982).

<sup>29</sup> Code Sec. 1035(c).

<sup>30</sup> It is unclear if the new rules cover independent contractors. Although a literal reading of the new rules might imply that coverage of independent contractors by Code Sec. 101(j) is not intended, reference to other Code sections and temporary regulations that treat self-employed individuals as employees creates some uncertainty. Pending guidance on this question, consideration should be given to complying with all the governing rules and exceptions of this

new section when insuring independent contractors. Note, however, that an independent contractor, in order to be covered by these rules, would still have to satisfy the “highly compensated” definition and would have to perform services for the employer. And, the employer would need to have an insurable interest in the life of the independent contractor.

<sup>31</sup> Code Sec. 414(q).

<sup>32</sup> Code Sec. 105(h).

<sup>33</sup> Code Sec. 101(a).

<sup>34</sup> Code Sec. 101(a)(2).

<sup>35</sup> Code Sec. 101(a)(2)(B).

<sup>36</sup> LTR 9625013 (Mar. 20, 1996).

<sup>37</sup> Examples include a policy transformed from one corporation to another in a corporate reorganization; a gift of a life insurance policy where there is no loan, or if a loan exists, it is less than the taxpayer’s basis in the contract; and a transfer between spouses that are U.S. citizens. Code Sec. 101(a)(2)(A); Rev. Rul. 69-187, 1 CB 45; LTR 8951056 (Sept. 27, 1989).  
<sup>38</sup> LTR 7734048 (May 26, 1977).

<sup>39</sup> Reg. §1.1001-2(a).

<sup>40</sup> Rev. Rul. 69-187, 1969-1 CB 45, LTR 8951056 (Sept. 27, 1989).

<sup>41</sup> Reg. §1.101-1(b); *B. Bean*, 14 TCM 786, Dec. 21,230(M), TC Memo. 1955-195.

<sup>42</sup> *Monroe v. Patterson*, 8 AFTR 2d 5142 (N.D. Ala. 1961).

<sup>43</sup> *C.E. Lambeth*, 38 BTA 351, Dec. 10,403 (1938); *Monroe v. Patterson*, *id.*

<sup>44</sup> *Lambeth*, *supra* note 43.

<sup>45</sup> Code Sec. 1041.

<sup>46</sup> Reg. §1.101-1(b)(4).

<sup>47</sup> *Haverty Realty & Investment Co.*, 3 TC 161, Dec. 13,709 (1944).

This article is reprinted with the publisher’s permission from the JOURNAL OF PRACTICAL ESTATE PLANNING, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher’s permission is prohibited. To subscribe to the JOURNAL OF PRACTICAL ESTATE PLANNING or other CCH Journals please call 800-449-8114 or visit [www.CCHGroup.com](http://www.CCHGroup.com). All views expressed in the articles and columns are those of the author and not necessarily those of CCH.