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Allianz Life Insurance Company of North America

The Transfer-for-Value Rule in life insurance, explained

Normally, life insurance proceeds which are payable as a result of the death of the insured are excluded from the taxable income of the beneficiary (or beneficiaries) of the policy. However, under a potential tax trap called the "Transfer-for-Value Rule," a substantial portion (or in some cases, all) of the death benefit may become taxable as ordinary income to the beneficiary.

The financial advantage of having life insurance will, of course, be proportionately eroded by any income tax that must be paid on the death benefit. So, it is essential for financial professionals and their customers to understand the rule and its potential impact.

Before transferring any interest in an existing life insurance policy, the Transfer-for-Value Rule, and its exceptions, should be taken into account. The proposed transaction should be carefully analyzed to be sure that the policy proceeds will not become taxed as income when received by a beneficiary as a result of the death of the insured.

What is the Transfer-for-Value Rule?

The "Transfer-for-Value Rule" can be found in Internal Revenue Code ("IRC") Section 101(a)(2). The rule provides that, if a life insurance policy or any interest in the policy is transferred for valuable consideration, then the income tax exclusion is not available to the beneficiary and the death proceeds are subject to federal income tax, unless an exception applies.

If the rule applies, what portion of the death benefit will be taxable?

Even if a transfer for value has occurred, that does not always mean that the entire death benefit is taxable income. In particular, the portion of the death benefit proceeds that is equal to the amount paid to acquire the policy or an interest in the policy, plus all future premiums paid (i.e., the basis in the policy), will be income-tax-free – but the remaining death proceeds will be taxed as ordinary income. [See Treas. Reg. Sec. 1.101-1(b)(3)(i)].

What types of transfers are considered a "transfer for value"?

Generally, any time the economic benefits of a life insurance policy are transferred by way of an assignment or otherwise, from the policy owner to a third party, for something of value (e.g., cash, exchange of promises, etc.), then the Transfer-for-Value Rule may apply.

Hypothetical examples of transfers for value:

- **Sale of a life insurance policy for cash:** Alan purchases a life insurance policy on Barbara's life that has a $100,000 death benefit. Alan pays premiums of $25,000 and later sells the policy to Clark for $35,000. Barbara dies and Clark receives the $100,000 death benefit. Clark may exclude from taxable income only the $35,000 he paid to acquire the policy, plus any subsequent amounts he paid as premiums. But the remainder of the death benefit will be taxable income to Clark.
- **Reciprocal beneficiary designations:** David names his cousin Earl as beneficiary of his life insurance policy in exchange for Earl naming David as beneficiary of a policy on Earl's life. Even though David and Earl have not exchanged ownership of their respective life insurance policies, a transfer for value has occurred. It is not necessary that every interest in the policy be transferred for the rule to apply. The right to receive any of the economic benefit of a life insurance policy in exchange for valuable consideration is sufficient to subject the death benefit to potential taxation.
- **Exchange of policies to fund a cross-purchase agreement:** Fran and Greg each own a life insurance policy insuring their own life. They are also the shareholders of a corporation. As shareholders, they agree to enter into a cross-purchase buy-sell arrangement. In order to fund the agreement, they each agree to "gift" their policy to each other. The exchange of policies will constitute valuable consideration and may subject the death benefit to potential taxation.

Exceptions to the Transfer-for-Value Rule

There are five safe-harbor exceptions to the Transfer-for-Value Rule identified in IRC Section 101(a)(2). As long as a transaction meets one of these safe-harbor exceptions, even if a life insurance policy or any interest in the policy is transferred for valuable consideration, the death benefits will remain income-tax-free to the beneficiary.

Here are the exceptions:

1. Transfer to the insured
2. Transfer to a partner of the insured
3. Transfer to a partnership in which the insured is a partner
4. Transfer to a corporation in which the insured is a shareholder or officer
5. Transfer to anyone whose basis is determined by reference to the original transferor's basis

In addition to the five exceptions above, if the policy is transferred to the spouse of the insured (or to the ex-spouse of the insured if incident to a divorce), then under IRC Section 1041, the transfer will be treated as a gift and not as a transfer for value.