



CODE SEC. 101: TRANSFERS-FOR-VALUE AND REPORTABLE POLICY SALES

Code Sec. 101(a)(1) provides the general rule that life insurance proceeds payable on the death of the insured are received income tax-free. However, any transfer of a policy for valuable consideration must meet two tests to determine whether the policy retains its income tax-free character. First, it must be within a traditional exception to the transfer-for-value rule and, second, it must not be a reportable policy sale.

If (1) the transfer is not within an exception to the transfer-for-value rule or (2) for purposes of the reportable policy sale test, there is no substantial family, business or financial relationship between the acquirer and the insured, the death proceeds will be taxable to the extent that they exceed the acquirer's investment in the contract. Importantly, while the placement of a new policy is not subject to the transfer-for-value rule, it is subject to the reportable policy sale test.

Gratuitous transfers, where the policy is transferred without consideration (that is, as a gift), are a special case.

THE TRANSFER-FOR-VALUE RULE

Code Sec. 101(a)(2) provides that, where a policy has been transferred for valuable consideration (the “transfer-for-value” rule) the policy loses its income tax-free character unless it is within one of the exceptions to the rule listed in Code Sec. 101(a)(2). There are two classes of exceptions.

Sec. 101(a)(2)(A) provides the first exception where the acquirer takes the transferor's basis. Traditionally, this exception applies where a policy is contributed to the capital of an entity, for example, where a policy is contributed to a corporation in exchange for stock or to the portion of a policy that is sold for less than the policy's fair market value (FMV).

Sec. 101(a)(2)(B) provides further exceptions to the rule “if such 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.” Of note, although a transfer to a partner of the insured is an exception to the rule, a transfer to a co-shareholder of the insured is not. For purposes of the transfer-for-value rule, a transfer to a “partnership” (or a “partner”) refers to a partnership for federal tax purposes.¹ A limited liability company (LLC) that is taxed as a partnership for federal tax purposes is a partnership for purposes of the rule, and a member of such an LLC is a “partner” for purposes of the rule.

If a transfer is not a reportable policy sale and was not a prior reportable policy sale, a transfer-for-value violation will be “cured” if the last 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.

GRATUITOUS TRANSFERS

The regulations distinguish between a transfer for valuable consideration and a gratuitous transfer (that is, a gift). Generally, in the case of a gift of the policy, the transferee will be able to exclude death proceeds from income equal to the amount the transferor would have been able to exclude plus any premiums and other consideration paid by the transferee.² For example, if insured A initially purchased a policy on their own life and later gifts it to their son B, B would receive the proceeds income tax-free because A would have received the proceeds income tax-free.

If a prior transfer of the policy violated the transfer-for-value rule (and a prior transfer was not a reportable policy sale), the subsequent transfer of the policy to the insured will restore the income tax-free character of the policy death benefit. For example, assume that A owns a policy insuring his own life. If A's son B purchases the policy from A, and B was not a partner with A, then the purchase would violate the transfer-for-value rule and B would only exclude the portion of death benefit from income equal to the purchase price plus subsequent premiums paid. If B later gifts the policy to sister S, the proceeds will continue to be taxable. If B gifted the policy back to A (rather than to S), the proceeds would be income tax-free.³

REPORTABLE POLICY SALES

The Tax Cuts and Jobs Acts of 2017 added the “reportable policy sale” test to Code Sec 101.⁴ If the transfer or acquisition of the policy is a reportable policy sale, the amount excluded from gross income is generally limited to the acquirer's investment in the contract (that is, the cost basis in the policy). In other words, the policy loses its income tax-free character. Reg. Sec. 1.101-1(c) provides that a reportable policy sale is the acquisition of an interest in a life insurance policy where the acquirer has no substantial family, business or financial relationship to the insured apart from the acquirer's interest in the life insurance contract.

Importantly, even if the current acquisition is within an exception to the transfer-for-value rule and is not a reportable policy sale (because the acquirer has a substantial family, business or financial relationship with the insured), if there was a prior reportable policy sale (due to a lack of a substantial family, business or financial relationship), the transaction remains a reportable policy sale and the policy loses its income tax-free character.

The only way to fully cure a prior reportable policy sale taint is to sell the policy to the insured for FMV and, if less than FMV is paid by the insured, only a pro rata portion of the death benefit is income tax-free.⁵

It is important to note that while a gift back to the insured will cure a transfer-for-value violation, it will not cure the prior reportable policy sale taint.

Let's examine the substantial family, business or financial relationships in detail.

A substantial family relationship⁶ is defined broadly as:

1. The individual
2. Their spouse
3. The individual's parent, grandparent or great-grandparent and that of their spouses
4. Lineal descendants of the individuals listed in 2 and 3
5. Spouses of any such lineal descendants and the lineal descendants of such spouses.

Of note, stepchildren and legally adopted children are considered descendants and spouses include unions recognized under state law.

A substantial business relationship⁷ exists if:

First, (1) the acquirer owns at least 80% of the business (directly or indirectly), and (2) the insured is a key person or materially participates (as an owner, employee or contractor) in an active trade or business. Generally, an individual materially participates in an active trade or business as an

owner, employee or contractor if such participation is regular, continuous, and substantial.⁸ A key person is defined as an officer or an individual who owns 20% or more of an active trade or business.⁹ In meeting the 80% test, an acquirer's ownership of a downstream entity will be attributed to an acquirer. For example, if A and B own the holding LLC 50/50 and the holding LLC owns 60% of company X (where company X owns 100% of the operating business), company X's 100% ownership will be attributed to the holding LLC and will meet the 80% test.¹⁰

Second, the policy is acquired through the acquisition of an active trade or business that owns a policy and will meet the 80% test.¹¹ In this case, there are a number of requirements regarding the insured's ongoing relationship to the acquired trade or business. These include (1) if the insured is an employee, (2) the insurance may be maintained to support the insured's retirement (qualified or nonqualified executive benefit plans) or to fund a buy-out of the insured's interest in the trade or business, or (3) the acquirer continues to operate the acquired trade or business.

A substantial financial relationship¹² exists when:

1. The acquirer and the insured have a common investment where the buy-out of the insured's interest by the acquirer is reasonably foreseeable.
2. The acquirer maintains the policy on the insured to fund the purchase of assets or to satisfy liabilities of the insured or the insured's estate, or heirs by reason of the death of the insured (consider the irrevocable life insurance trust or satisfying a bank loan to the insured payable on the insured's death).¹³
3. The acquirer is a charitable organization that previously received from the insured "either financial support in a substantial amount or significant volunteer support".

In addition to a substantial family, business or financial relationship, there are a few general exceptions to what would otherwise be characterized as a reportable policy sale.¹⁴ For example, (1) the transfer of an interest between entities where the transferee (the acquirer) has the same beneficial ownership as the transferor (defined as the ownership of the two entities not varying by more than 20%) or (2) a 1035 exchange.

If the acquirer was purchasing a new policy on the insured and would have an insurable interest in the insured, then it is highly likely that they will have a substantial family, business or financial interest in the insured. In fact, the substantial relationship definitions are broader than insurable interest definitions. For example, absent a common ownership of a closely held business, an individual would rarely have an insurable interest in siblings, cousins, or second cousins. However, for purposes of the reportable policy sale test, an individual (acquirer) would have a substantial family relationship with siblings (by way of a common parent), cousins (by way of a common grandparent) and second cousins (by way of a common great grandparent).

1035 EXCHANGES

In 2023, the final regulations requirement that the acquirer of a new policy in a 1035 exchange must have a substantial family, business or financial relationship with the insured to maintain the income tax-free character of the policy death proceeds was relaxed by proposed regulations.^{15, 16}

Rather than requiring that the new policy in a 1035 exchange not be a reportable policy sale, the proposed regulations only look to whether the original policy met the reportable policy sale test in whole or in part. That new proposed regulation section provides:

1. If no part of the original policy proceeds was a reportable policy sale, that is, if the proceeds would be entirely income tax-free, the new policy proceeds will also be entirely income tax-free.
2. If the original policy was only partially income tax-free, for example, if \$6 million of a \$10 million original policy was income tax-free, only \$6 million of the new policy plus any subsequent premium payments would be income tax-free.¹⁷

REPORTING OBLIGATIONS

The acquirer of a policy in a reportable policy sale must complete Form 1099-LS for each policy acquired. Information provided includes the date of sale, the amount paid, the identity of each acquirer, the identity of and amount paid to any sellers (payment recipients), and the identity of the policy issuer. Copies of Form 1099-LS must be provided to the issuer which must provide to the IRS the transferor's name, address, TIN, and investment in the contract. Further reporting obligations on the part of the issuer arise on the death of the insured.

CODE SEC. 101(J)

Finally, it is important to consider the ramification of Code Sec. 101(j). Code Sec. 101(j) applies to employer-owned policies issued after August 17, 2006. The notice and consent requirement of 101(j) must be met prior to issuance of the policy or before the filing of the tax return in the year the policy was issued. If this was not done for existing employer-owned policies, the policies' death benefit loses its income tax-free character. Generally, once the policies are tainted, that taint cannot be removed. The only exceptions are for policies transferred to the insured or to an individual who is a minority owner. In these cases, Code Sec. 101(j) should not apply. Policies transferred to an individual who is a majority owner will continue to be subject to 101(j) and the only way to cure the

101(j) violation is to issue new policies being sure to sign the notice and consent form prior to issuance. In the business setting, as a precautionary measure, it is advisable to consider (1) whether the policies will be owned by the business or an individual owner, signing 101(j) notice and consent form prior to issuance of any and all new policies or (2) carefully documenting why, at the time of issuance, the notice and consent form was not signed for a particular policy.

IN CLOSING

The reportable policy sale test and its requirement of a substantial family, business or financial relationship adds a new element to evaluating whether the purchase of a new policy or the transfer of an existing policy maintains its income tax-free character in the hands of the acquirer. In most cases, for example, where the acquirer has or would have an insurable interest, meeting the test is relatively straightforward. However, for many transfers, including the transfer of an entity holding insurance policies or where the transfer partially fails the reportable policy sale test, the analysis can be quite complex. The bottom line is this: before transferring an in-force policy, a client's legal and tax advisors should take extra care to understand the ramification of the transfer and, in the case where the policy will lose its fully income tax-free character, whether there are better options available.

ENDNOTES

- 1 For the balance of this article, the term “partner” means a partner for federal tax purposes not in the generic sense of the word. Likewise, references to a “partnership” or an “LLC” assumes that the entity is taxed as a partnership for federal tax purposes.
- 2 Treas. Reg. Secs. 1.101-1(b)(2)
- 3 If, however, A wanted the proceeds paid to B, would the Service argue that B transferred the policy back to A in consideration of being designated the beneficiary, rendering the transfer part gift part sale? Arguably, A designating B as the beneficiary is a gratuitous act on A's part.
- 4 Code Sec. 101(a)(3) and Treas. Reg. Sec. 1.101-1
- 5 Treas. Reg. Secs. 1.101-1(b)(1)(ii)(B)(3) and 1.101-1(b)(2)(iii)
- 6 Treas. Reg. Sec. 1.101-1(d)(1)
- 7 Treas. Reg. Sec. 1.101-1(d)(2)
- 8 Code Sec. 469(h)
- 9 The number of key persons is limited to the greater of (A) 5 individuals or (B) the lesser of 5% of the total officers and employees or 20 individuals. Code Sec. 264(e)(3).
- 10 Treas. Reg. Sec. 1.101-1(f)(1) The regulation does not appear to prorate holding LLC's interest based on its 60% ownership of company X and the regulations do not provide an example.
- 11 Treas. Reg. Sec. 1.101-1(d)(2)(ii)
- 12 Treas. Reg. Sec. 1.101-1(d)(3)
- 13 In the lion's share of irrevocable life insurance trusts, the trust will have a substantial family relationship with the insured since the beneficiaries will typically be a spouse and lineal descendants of the insured. However, a trust that pays 25% of the policy proceeds to an unrelated friend of the insured (and who does not have a substantial family or business relationship with the insured) would appear to be a partial reportable policy sale. However, the trust (acquirer) would have a substantial financial relationship with the insured if it maintains the policy to fund the purchase of assets or to satisfy liabilities of the insured or the insured's estate or heirs by reason of the death of the insured.
- 14 Treas. Reg. Sec. 1.101-1(c)(2)
- 15 Treas. Reg. Sec. 1.101-1(b)(2)(v)
- 16 Proposed Regulations adding Reg. Sec. 1.101-1(b)(2)(iv)
- 17 This proposed regulation (and in fact, the requirement that the purchase of a new policy has a substantial family, business or financial relationship) is somewhat puzzling in the sense that, if an acquirer has an insurable interest in the insured's life, the acquirer most likely has the requisite substantial relationship with the insured. If, on the other hand, the policyowner exchanging the policy does not have a current insurable interest in the insured's life, an insurance carrier will be unlikely to issue the new policy.

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