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New rules for transfer for value

New treasury regulations rewrite many transfer for value rules and introduce new reporting requirements

On October 31, 2019, the IRS issued final regulations addressing changes created by the Tax Cuts and Jobs Act of 2017 (TCJA), which introduced the concept of Reportable Policy Sales and amended the Transfer for Value rules. The IRS used the opportunity to not only explain the new Reportable Policy Sale rules, but to also rewrite some long-standing and fundamental Transfer for Value rules.

Overview

Generally, death benefits from life insurance policies are received income tax free under Code Section 101. Section 101 also contains an exception known as the "Transfer for Value" rule, which makes death benefit income taxable in certain circumstances.

A Transfer for Value occurs when there is a transfer of an interest in a life insurance policy for valuable consideration and an exception doesn't apply. The exceptions apply if either (1) the policy is transferred to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or shareholder ("certain transferee exception") or (2) the transferee's basis in the contract or interest therein is determined in whole or in part by reference to the income tax basis of the transferor ("carryover basis exception").

The TCJA introduced a new concept known as a "Reportable Policy Sale." Generally, a Reportable Policy Sale is any direct or indirect acquisition of an interest in a life insurance contract if the acquirer doesn't have a substantial family, business, or financial relationship with the insured.

A Transfer for Value can occur when there is not also a Reportable Policy Sale. For example, when a policyowner/insured sells the policy to a co-shareholder to set up a cross purchase agreement. But, if a Transfer for Value is also a Reportable Policy Sale, then the exceptions to the Transfer for Value rule are not available. This generally means much of the death benefit will be income taxed, even if the transfer is to an excepted transferee or has a carryover basis.
The existence of a Reportable Policy Sale also triggers reporting requirements.

Reportable Policy Sales may occur without there being a Transfer for Value. For example, a Reportable Policy Sale can occur even if a policy is acquired by *gift* rather than by sale.[1]

What is a Reportable Policy Sale?

For there to be a *Reportable Policy Sale* there must be two elements:

1) An **acquisition** of an interest in a life insurance policy, either directly or indirectly; and

2) The lack of a **substantial family, business, or financial relationship** between the acquirer and the insured apart from the acquirer's interest in the life insurance contract. I.R.C. §101(a)(3)(B)

[1] See, Treas. Reg. § 1.101-1(b)(2)(i).

When does an acquisition occur?

A *direct acquisition* occurs when there is a "transfer of an interest in a life insurance contract" from one party to another.[2]

An *indirect acquisition* occurs when ownership of a policy is held by an entity and remains with that entity, but the beneficial ownership of the entity changes (e.g., new partner buys into the company that owns the policy).[3]

Observations

As stated, the addition of the Reportable Policy Sales concept to Section 101 has changed how some death benefit will be taxed and also imposed new reporting requirements. Although commentators and practitioners are still analyzing the new rules and how they apply to typical transactions, there are a few observations that can be made.

- **Extra attention should be paid to policies that will be owned by businesses.** A transfers of an interest in a life insurance policy that formerly qualified for the "certain transferee exception" or the "carryover basis exception" could now result in income taxable death benefit, if the acquirer does not also have the requisite substantial relationship with the insured.

  For example, if a business-owned life insurance policy is transferred to another business as part of a tax-free merger or acquisition (i.e., tax-free asset reorganization), the "carryover basis exception" that formerly preserved tax-free death benefit will generally no longer be available if:

  - The businesses do not have common ownership;[4] or
  - The insured is no longer an employee AND the acquirer does not have 1) any obligation upon the insured's death to purchase the assets of the insured or to satisfy the insured's liabilities[5]; or 2) to satisfy other liabilities triggered by his death.[6]

  Possible Solution? Businesses might be able to make sure they have a substantial relationship with an insured who is a former employee **if the business offers a survivor benefit to the insured's family or estate**. For example, a survivor benefit that is intended to satisfy typical funeral costs of $5,000 - $10,000 might be something for businesses to offer in nearly any situation where the business owns a policy on an employee or one of its shareholders/partners.[7]

- Once a policy is "stained" by a Transfer for Value event that is *also* a Reportable Policy Sale, it is very difficult to "clean" the policy. In fact, it seems the only way to clean the policy is to sell – not give – the policy back to the insured.

[2] Treas. Reg. §1.101-1(e)(3)(i).
[3] Treas. Reg. §1.101-1(e)(3)(ii).
[4] Treas. Reg. §1.101-1(c)(2)(i) (the individual owner's interests in the entities must not vary by more than 20%)
[5] " . . .or the liabilities of the insured's estate, heirs, legatees, or other successors in interest." Treas. Reg. §1.101-1(d)(3)(ii).
[6] Treas. Reg. §1.101-1(d)(3)(ii).
[7] Although the regulations state that a substantial relationship with the insured might exist if the insured is entitled to a survivor benefit, the regulations do not state anything about how large this survivor benefit should be. See, Treas. Reg. §§1.101-1(d)(2)(ii)(2) and 1.101-1(d)(3)(ii).

- A revocable beneficiary designation is not a transfer of an interest in a life insurance policy.[8] Also, "valuable consideration" (basically, that which is provided by the transferee to the transferor) is defined as cash or other consideration reducible to a money value.[9]

As with all tax or legal analysis, a client must consult with his or her own tax advisor to determine how the new rules might apply to his or her own fact scenario.

Reporting required

The occurrence of a Reportable Policy Sale generally triggers certain reporting requirements on the part of the acquirer and the issuer of the policy. In addition, death benefit that is paid with respect to a policy that was transferred in a reportable policy sale generally must also be reported by the insurance company (so the IRS knows much of it is likely income taxable). We'll provide more details about what and how to report in future articles.

Exceptions – Acquisitions that are NOT Reportable Policy Sales

The regulations contain some exceptions for transactions that might otherwise be a direct or indirect acquisition of a policy interest.

- **Common ownership exception.** Where there is common ownership or control between parties.[10]
- **Section 1035 exceptions.** Where policies are acquired by a **life insurance company in a 1035 transaction** or a policyholder in a **1035 transaction as long as the policyholder has the requisite substantial relationship** with the insured at the time of the exchange.[11]
- **In addition, with respect to indirect acquisitions, the following exceptions also apply.**
    - **Grandfathered policy exception.** Where the entity acquired the interest in the life insurance policy before 1/1/2019.[12]
    - **Prior compliant reportable policy sale exception.** Where the entity acquired the interest in a prior reportable policy sale that was reported **in compliance with the reporting requirements**.
    - **C corporation exception.** An acquisition of an interest in a **C corporation** if no more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts.[13]
    - **De minimis ownership exception.**
      If no more than 50 percent of the gross value of the assets of the business acquired consists of life insurance contracts

      AND

      after the acquisition, the person indirectly acquiring the interest and his or her family members own, in the aggregate 5% or less of the interests in the entity, trust or estate.

[8] Treas. Reg. §1.101-1(e)(2).
[9] Treas. Reg. §1.101-1(f)(5).
[10] See, Treas. Reg. §1.101-1(c)(2)(i) (same beneficial owners as long as each owner's interest doesn't vary by more than 20%) and Treas. Reg. §1.101-1(c)(2)(ii) (corporations that are members of an affiliated group).
[11] See, Treas. Reg. §1.101-1(c)(2)(iv) (insurance company that issues a life insurance contract in a 1035 exchange) and Treas. Reg. §1.101-1(c)(2)(v) (policyholder with requisite substantial relationship).
[12] Treas. Reg. §1.101-1(c)(2)(iii)(A).
[13] Treas. Reg. §1.101-1(e)(3)(ii).

When does an acquirer have a substantial relationship?

Although the existence of a substantial relationship is relevant for all acquisitions, it is particularly important when a business is involved. When there is no business purpose or involvement with the acquisition, a Reportable Policy Sale is primarily a concern if the person acquiring the policy is not part of the insured's immediate or extended family.

When a business is involved in an acquisition, either as an owner or acquirer of the policy or because the policy is acquired for business purposes, the "substantial relationship" question is more complex. In general, a business probably has the requisite relationship with the following groups of people: current employees, owners, and borrowers.

With respect to former employees, as discussed above, there generally must be a continuing financial obligation of some kind triggered by the former employee's death.

Generally, a substantial relationship exists in the following situations:

1. The insured generally has a ***substantial family relationship*** with himself or herself, and also with the insured's great-grandparent and anyone who is a descendant of that great-parent (basically, extended family to second cousins, and even their descendants). And the spouses of these relatives too.
2. The insured generally has a ***substantial business relationship*** with a business if either:
    - The insured is a key person or materially participates in an active trade or business.[14]
    - The business acquired an active trade or business and all the following requirements are satisfied:
        - A. The interest in the life insurance policy is acquired either:
            - As part of the acquisition; or
            - From a person owning –
                - significant property that is leased to the business or
                - life-insurance policies held to facilitate the succession of the ownership of the business.
        - B. The insured meets one of the following definitions:
            - The insured is an employee of the business immediately before the acquisition[15]; or
            - Both of the following are true:–
                - The insured was a director, highly compensated employee or highly compensated individual with respect to the business[16] AND
                - the business has ongoing financial obligations to the insured with respect to the insured's employment by the trade or business.
        - C. The acquirer continues to carry on the trade or business and it does not include investing in interests in life insurance contracts.

[14] Treas. Reg. §1.101-1(d)(2)(i). In addition, at least 80% of the active trade or business must be owned (directly or indirectly) by the acquirer or beneficial owners of the inquirer.
[15] Treas. Reg. 1.101-1(d)(2)(ii)(A)(1). For this purpose, "employee" is defined under Code §101(j)(5)(A).
[16] Within the meaning of Code § 101(j)(2)(A)(ii).

3. The insured generally has a ***substantial financial relationship*** with the acquirer of an interest in a policy if any of the following circumstances exist:
    - The insured and the acquirer have a common investment and a buy-out of the insured's interest on death is reasonably foreseeable.
    - The acquirer maintains the life insurance contract on the insured to provide funds to:
        A. Purchase assets of the insured or the insured's estate upon the insured's death;
        B. Satisfy liabilities of the insured that arise upon or are triggered because of the insured's death; or
        C. Satisfy other liabilities arising upon or by reason of the death of the insured.
    - The acquirer is a charitable organization that received financial or volunteer support from the insured.

Final Thoughts

Although the concept of a reportable policy sale and the changes made to the transfer for value rules require additional analysis when there is a change in the owner of a policy or an entity that owns a policy, the basic rules on taxation of death benefit have not changed.

Death benefit remains income tax-free to most recipients. Just like before the new rules were issued, any transfer of a life insurance contract or any interest in a life insurance contract requires a determination of whether it is a transfer for valuable consideration and, if so, whether an exception applies. The new rules regarding reportable policy sales will now require an additional layer to the analysis.

If it is concluded that an ownership change of a policy or a business is a reportable policy sale, the consequences must be evaluated. Further, planning (such as including a survivor's benefit for former employees) might be possible to change that conclusion.

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