

Transfers of life insurance policies after Tax Cuts and Jobs Act (TCJA) of 2017

Background

Life insurance contracts have long been subject to the transfer for value rule, which sometimes eliminates the benefit of tax-free death proceeds following a nonqualifying policy transfer. This rule is designed to reduce the incentive for life insurance to become a “wager” on an individual’s life expectancy; therefore, it limits the income-tax treatment of death proceeds to purposes for which life insurance is intended.

Briefly, a transfer for value results in a taxable death benefit, unless the transfer is:

- To the insured,
- To a partner of the insured or a partnership in which he/she is a partner,
- To a corporation in which the insured is an officer or shareholder,
- Subject to a carryover basis exception, or
- To a trust that is a grantor trust with respect to the insured.¹

Reportable policy sales

A potentially broad exception to the transfer for value rule² was created by the Tax Cuts and Jobs Act (TCJA) of 2017 for “reportable policy sales.” Under that provision, a policy acquisition³—directly or indirectly—that might otherwise qualify for one of the exceptions to the transfer for value rule will not qualify if “the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer’s interest” in the life insurance policy.⁴ The term “indirectly” applies the reportable policy sale rule to acquisitions through a partnership, trust, or other entity that holds an interest in the life insurance contract.⁵

The reportable policy sales provision has been widely viewed as applying only to commercial transfers, such as life settlements; however, it has potential implications for mergers and acquisitions. Regulations generally include transfers occurring under these circumstances, as well as other business-owned life insurance transactions. For additional details, see [Transfer for value/reportable policy sale regulations overview](#) and [Transfer for value/reportable policy sale regulations Q&A](#).

Example

Bell Software Solutions, Inc., owns a life insurance policy on a former key employee, Robert, who was employed there for 10 years and contributed heavily to the company’s early success. Robert left to start his own competing software company. Bell Software was acquired in 2018 by a larger firm, Westway, Inc., which now owns the life insurance policy on Robert. Westway has no family, business, or financial relationship with Robert. The reportable policy sales provision would generally apply to the policy on Robert, meaning that the death benefit will be taxable to Westway to the extent that it exceeds Westway’s carryover basis.

Ordinarily, a transfer for value problem can usually be remedied by a transfer to an exempt transferee, such as the insured, a partnership in which he/she is a partner or a corporation in which the insured is an owner or officer. Reportable policy sales are not generally cured by such a transfer. However, with a transfer to the insured for the full fair market value of the policy, the income tax-free death benefit treatment can be restored.

Comments

If the issue of the insured's family or business relationship to the policyowner sounds like a familiar concept, it is. Rules implemented in 2006 result in a taxable death benefit if certain requirements are not met for both notice/consent **and** the presence of certain business or family relationships.⁶ Those rules look to the relationship of the insured to the employer or former employer, or to whether the proceeds are paid to the employee's heirs.⁷ The notice/consent requirement is imposed at the time the policy is issued. The regulations do not use the same language or analysis; however, many of the circumstances that satisfy the notice/consent requirements will fall within the requirements set forth in the regulations.

Conclusions

Aside from the life settlement market, most policy transfers for family or business reasons should be able to avoid the application of these rules; however, an analysis of the reportable policy sales implications should always be considered, particularly in mergers and acquisitions.

Business owners who acquire a business should be advised that if the business owns life insurance on a former employee, the issue of a reportable policy sale could come up. In a worst-case scenario, the death benefit could be income taxable to the extent that it exceeds the business's basis in the contract. For additional details, see [Transfer for value/reportable policy sale regulations overview](#) and [Transfer for value/reportable policy sale regulations Q&A](#).

¹ See IRC Sec. 101(a)(2)(A); Rev. Rul. 2007-13, 2001-11 IRB 684.

² Technically it is an exception to the exceptions; meaning it defines a context in which the transfer for value exceptions will not apply.

³ According to page 339 of the Conference Report, the provision is intended to apply to purchases of an existing contract.

⁴ IRC Sec. 101(a)(3)(B), as added by TCJA 2017, effective for transfers after 2017.

⁵ IRC Sec. 101(a)(3)(B).

⁶ See IRC Sec. 101(j).

⁷ Specifically, the death benefit will be subject to income tax of amounts in excess of basis unless notice/consent is satisfied *and* (a) the insured was an employee during the 12 months prior to death, (b) the insured met any of several requirements *when the policy was issued*, such as being a director, or one of certain highly compensated employees, or (c) the death benefit is payable to the insured's heirs, or used to buy out the insured's interest in the business. IRC Sec. 101(j).



[principal.com](https://www.principal.com)

Insurance products issued by Principal National Life Insurance Company (except in NY) and Principal Life Insurance Company[®]. Plan administrative services offered by Principal Life. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities offered through Principal Securities, Inc., Member SIPC and/or independent broker/dealers. Referenced companies are members of the Principal Financial Group[®], Des Moines, IA 50392.

The subject matter in this communication is educational only and provided with the understanding that Principal[®] is not rendering legal, accounting, investment, or tax advice. You should consult with appropriate counsel, financial professionals, and other advisors on all matters pertaining to legal, tax, investment, or accounting obligations and requirements.

No part of this presentation may be reproduced or used in any form or by any means, electronic or mechanical, including photocopying or recording, or by any information storage and retrieval system, without prior written permission from the Principal Financial Group[®].

Principal[®], Principal Financial Group[®] and the Principal logo design are registered trademarks of Principal Financial Services, Inc., a Principal Financial Group company, in the United States and are trademarks and service marks of Principal Financial Services, Inc., in various countries around the world.