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Transfer for value/reportable policy sale regulations Q & A

Summary

Reportable policy sales are generally transfers of life insurance policies occurring either as a life settlement or certain commercial transfers, but can also be triggered by certain personal sales of a policy.[1] In many cases, a reportable policy sale may lead to taxation of some or all of the death benefit. Regulations defining the terminology and application of the reportable policy sale rules are important for understanding which transactions are exempted from them and when the death benefit may become taxable.[2] It's important to recognize that the regulations take a broad approach, expanding on the transfer for value rules that have been in the Internal Revenue Code for decades. The following is intended to describe general highlights of the rules. The regulations are complex, so local tax and legal counsel should be consulted for more details.

Transfers for value

Q1| How do the regulations define a transfer for value?

The regulations define a "transfer for valuable consideration" as "any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value."[3]

The "transfer of an interest in a life insurance contract" means that there's a transfer of any interest in the policy, including any transfer of the title to, possession of, or legal or beneficial ownership of the policy. The issuance of a policy to a policyholder is not a transfer for this purpose.[4] It also includes the creation of an enforceable right to receive all or part of the proceeds.

The regulations specifically exclude the following from the definition of a "transfer of an interest in a life insurance contract":

- A *revocable* beneficiary designation
- A collateral assignment[5]

Regulations issued in 2019 also characterize 1035 exchanges as transfers for value, but proposed regulation issued in 2023 explain that this was a mistake, and the newer proposed regulations make it clear that a 1035 exchange is not, by itself, a transfer for value; it is just that the exchange does not "cleanse" a policy that is already tainted by a reportable policy sale. The proposed regulations are designed to have retroactive effect on this topic.

Our analysis: The "reducible to a money value" language could represent a narrowing of what the IRS will view as valuable consideration. Prior to the regulations, a transfer for value was viewed as encompassing a wider range of transactions, including some where no cash or property exchange occurred.

Q2| How do the regulations change the analysis of a transfer for value?

Under prior law, the analysis was limited to:

(a) whether a transfer for valuable consideration occurred, and
(b) if so, whether the transferee was exempt under the statute or related guidance.[6]

Previously, if the transferee was covered by one of the statutory exceptions, no further consideration was required of what the relationship was between the insured and the transferee, and the taxation of the death benefit was not affected by the transfer for value rule.

The regulations impose additional steps into the analysis, as follows:

(a) Determine whether a transfer of an interest in a life insurance policy occurred (as defined in the regulations), even if it was gratuitous.[7]
(b) Determine whether the transfer is a reportable policy sale or the policy was ever previously transferred in a reportable policy sale.
(c) Determine whether the transfer falls under one of the traditional exceptions to the transfer for value rule. If the transfer is a reportable policy sale or a transfer for value with no exception, the amount of excludable death benefit may be limited.

Q3| How is the death benefit taxed as a result of a transfer for value?

If the transfer is not a reportable policy sale (meaning that it's either excluded from reportable policy sales rules or the insured has a substantial business, financial, or family relationship to the transferee) and the policy was never transferred in a reportable policy sale, the traditional transfer for value analysis takes place. If the transfer is also to a transferee who's exempt under the transfer for value rule, the death benefit is excluded from income tax as a general rule. Otherwise, previous or subsequent transactions may change the degree to which the death benefit is excludable from taxable income.[8]

Reportable policy sales

Q4| What is a reportable policy sale?

A reportable policy sale is generally a direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of acquisition, no substantial business, financial, or family relationship to the insured (as defined in the regulations and explained in Q6–Q8, below), apart from the interest in the policy.[9]

Exceptions to this rule are explained in Q5. The regulations point out that even if a transferee (acquirer) meets a statutory exception to the transfer for value rule (such as being a partner of the insured), that alone doesn't confer a substantial business or financial relationship, such as would avoid the reportable policy sale rules. Similarly, a transferee that doesn't meet a statutory exception to the transfer for value rule can, nonetheless, have a substantial business, financial, or family relationship to the insured.[10]

Q5| Are there any exceptions to the definition of a reportable policy sale that don't rely on a substantial business, financial, or family relationship?

Yes. The regulations carve out several exceptions to the definition of a reportable policy sale. The following transactions aren't reportable policy sales:[11]

(a) A transfer of an interest in a life insurance contract between entities with the same beneficial owners (based on a test in which ownership does not vary by more than 20%).
(b) A transfer between corporations that are members of an affiliated group that files a consolidated income tax return for the year of the transfer.
(c) An indirect acquisition in which the policy owned by the entity being acquired was acquired before January 1, 2019, (or was acquired in a reportable policy sale that was reported as required by regulations).
(d) An indirect (and essentially, de minimis) acquisition of an entity-owned policy where (i) the trust or business entity being acquired owns a policy, and not more than 50% of the entity's assets are life

insurance contracts; and (ii) after the acquisition, generally not more than 5% of the entity being acquired is owned by the acquirer (and the acquirer's family, if the acquirer is an individual).

(e) Certain indirect acquisitions through C corporations[12] (see Q9 for details).

Q6| What is a substantial business relationship under the regulations?

A substantial business relationship between the insured and the acquirer of a policy will exist in either of the following circumstances:[13]

(a) The insured is a key person[14] or materiallyparticipates[15] in an active trade or business as an owner, employee, or contractor, and at least 80% of the business is owned (directly or indirectly) by the acquirer or its beneficial owners.

Our analysis: If the acquirer owns less than 80%, perhaps because it purchased less than 80% of the acquired company, then the acquirer and key person don't have a substantial business relationship under this clause. But an acquirer could have a substantial business relationship with the insured under one of the other provisions below. This first provision doesn't require that the acquirer continue operating the acquired business, and it includes contractors and owners who aren't employees.

(b) The policy is acquired as part of a trade or business acquisition, and
  (i) the insured is an employee, including an officer, director, or highly compensated employee,[16] immediately preceding the acquisition, or
  (ii) the insured was a director, highly compensated employee[17], or highly compensated individual[18] of the acquired business when the policy was issued, and the acquiring business has a financial obligation to the insured with respect to the insured's employment.

Both of these exceptions under (b) are also conditioned on the acquiring business either continuing to operate the business it acquired or using the acquired business in its own active trade or business. (A "business" for this purpose means something other than the business of purchasing life insurance.)

Our analysis: If the acquirer continues operating the business (or uses the acquired business in their own active business), this provision appears to cover policies on those employed immediately prior to the acquisition, and former employees who were gone at the time of the acquisition, but with respect to whom there is an ongoing financial obligation.

Q7| What is a substantial financial relationship under the regulations?

A substantial financial relationship exists in each of the following circumstances:[19]

(a) The acquirer or the owners of the acquirer have a common investment with the insured (other than the interest in the policy) and a buy-out of the insured's interest in the common investment by the co-investors after the insured's death is reasonably foreseeable.

(b) The acquirer maintains the life insurance policy to provide funds to purchase assets of or satisfy liabilities of the insured, or to satisfy liabilities arising at the insured's death.

(c) The acquirer is a charitable organization that has previously received substantial financial support or significant volunteer support from the insured.

Our analysis: Parts (a) and (b) should create a substantial financial relationship for transfers of policies for buy-sell purposes, whether they are cross-owned or entity-owned. Note that satisfying this substantial financial relationship triggers an exception to the reportable policy sale rule, but one of the traditional exceptions to the transfer for value rule is still necessary to avoid taxation under that rule. Part (c) should be helpful for transfers of a policy to a charitable organization with which the donor has a history of financial or volunteer support.

Q8| What is a substantial family relationship under the regulations?

A substantial family relationship exists between the insured and himself or herself, parents, grandparents, great-grandparents, as well as lineal descendants, and a spouse of the insured or any of the foregoing relatives (including domestic partner or similar relationship under state law). In addition, a family relationship exists between the insured and a former spouse, if there is a transfer of a policy incident to a divorce.[20]

Q9| What is the "carve-out" for C corporations?

An acquisition of an interest in a C corporation is subject to a special rule. In general, the acquisition of an interest in a business entity that holds a life insurance policy will result in an indirect acquisition of the policy, for purposes of the reportable policy sale rule. However, the regulations state that if the entity is a C corporation, and the gross assets of the C corporation are less than 50% life insurance contracts, the acquisition won't be treated as the indirect acquisition of the life insurance owned by the C corporation.[21]

Our analysis: This exception provides relief (beyond the 5% de minimis exception in Q5(d)) for many stock acquisitions of C corporations that hold life insurance policies, so long as the company's gross assets are less than 50% life insurance. By exempting them from the definition of an "indirect acquisition," they don't rise to the level of being a reportable policy sale.

Q10| How is the death benefit taxed as a result of a reportable policy sale?

If the transfer is a reportable policy sale, the death benefit is generally subject to income tax, to the extent it exceeds the consideration paid, plus other amounts, such as subsequent premiums.[22] Subsequent dispositions could result in a higher exclusion amount, within limits, as described below.

Q11| Can a reportable policy sale be cured by transferring the life insurance contract back to the insured?

In a departure from the preexisting treatment of transfers for value, the regulations provide that a transfer back to the insured won't "cure" a reportable policy sale. Once a reportable policy sale has occurred, the income tax treatment of the death benefit is generally subject to income taxation. However, if the subsequent transfer of the contract back to the insured is for its full fair market value, the full exclusion of the death benefit from income tax is available. If the insured pays less than fair market value, the reacquisition of the policy will be treated as a bargain sale, meaning the proceeds will be partially taxable and partially tax-exempt, in proportion to the consideration paid for the policy.[23]

Q12| Can a reportable policy sale be cured by transferring the life insurance contract to an exempt transferee, like a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an owner or officer?

Once a reportable policy sale has occurred, a transfer to an exempt transferee will not fully "cure" the treatment of the death benefit (other than to the insured for fair market value under the rules discussed in Q11 above). The amount of the proceeds that will be excludable from gross income will be limited to the sum of (a) the higher of the consideration paid by the transferee or the amount that would have been excludable by the transferor had the transfer not occurred, plus (b) the premiums and other amounts subsequently paid by the transferee on the policy.[24]

Our analysis: It appears that most traditional business uses (and transfers) of life insurance would likely meet one of the definitions that avoid a reportable policy sale. In such cases, the preexisting transfer for value analysis would apply. However, it's possible that certain transfers could trigger the reportable policy sale consequences, such as a business merger or acquisition in which the business being acquired has retained a policy on a former employee for whom there is no financial obligation.

Impact on specific business transactions

Nonqualified deferred compensation arrangements. Neither the initial issue of a policy nor the eventual transfer of it to the insured will trigger the reportable policy sale rules. A transfer to the insured is subject to an exception to the transfer for value rule, and the insured is within the "family relationship" exception to the reportable policy sale rule. If the plan sponsor is acquired by another company while the arrangement is in place, either the current employment of the executive or an ongoing financial obligation of the company to the executive, if employment has ceased, will generally result in an exception to the reportable policy sale rule.

Buy-sell funding arrangements. Policies funding a buy-sell obligation should qualify for either the business or financial relationship exceptions to the reportable policy sale rule. This would likely hold true even if a transfer of an existing policy to the company or a co-owner is used to fund a buy-sell obligation. As under prior law, the transfer of a policy to a co-shareholder (assuming they aren't partners in an entity taxed as a partnership) remains a potential transfer for value problem, which could result in a taxable death benefit.

Key person coverage. The issuance of a policy providing key person coverage during an individual's employment won't trigger either a reportable policy sale or a transfer for value. If the employer is sold during the key person's employment, the insured's status as an employee should establish a substantial business relationship, which would establish an exception to the reportable policy sale rule. The same holds true if the key person has left, but the business continues to have a financial obligation to the insured, such as a deferred compensation or buyout obligation. If the key person is no longer employed and there is no continuing financial obligation, an acquisition of the company could trigger a reportable policy sale of the policy.

Split dollar arrangements. The creation of an endorsement split dollar arrangement between an employer and the insured employee is a transfer, but assuming there has been no previous reportable policy sale, it should qualify for the exception to the transfer for value rule as a transfer to the insured. For loan split dollar arrangements between an employer and employee, a collateral assignment alone is not a transfer, so it shouldn't trigger a reportable policy sale. Even if it did, the employer to whom it's assigned (the plan sponsor) would most likely have a substantial business relationship with the insured.

Effective dates

For purposes of determining whether a transfer constitutes a reportable policy sale, the regulations took effect for reportable policy sales (and death benefit proceeds paid under such policies) occurring after December 31, 2018. For purposes of determining the amount of the death benefit exclusion, the regulations are effective for transfers occurring after October 31, 2019. [25] In addition, certain indirect acquisitions are exempted from the reportable policy sales rules if the entity holding the policy acquired it prior to 2019.[26]

Conclusions

The reportable policy sale regulations change the analysis of transactions involving a transfer for value, while also redefining the term "transfer for value." Financial professionals will need to keep these rules in mind in any transaction involving a direct or indirect transfer of a policy.

[1] See IRC Sec. 101(a)(3), as added by TCJA 2017 (P.L. 115-97, Sec. 13522(a)), effective for transfers occurring after December 31, 2017.
[2] See TD 9879, 84 Fed. Reg. 58460 (October 31, 2019); Treas. Regs. §§1.101-1, 1-101-6, 1.6050Y-1to 1.6050Y-3. The scope of this analysis is limited to the income tax impact of the regulations. It is not intended to address the reporting requirements.
[3] Treas. Reg. §1.101-1(f)(5).
[4] Treas. Reg. §1.101-1(e)(2); see Prop. Regs. §§1.101-1(b)(2)(iv), 1.101-1(c)(3) and Q1of this article for the treatment of policies issued in a 1035 exchange.
[5] Treas. Reg. §1.101-1(e)(2).
[6] See IRC Sec. 101(a)(2).
[7] While a gratuitous transfer, standing alone, does not trigger the transfer for value rule, it can trigger a reportable policy sale if the transferee lacks a substantial business, financial or family relationship to the insured. See Treas. Reg. §1.101-1(b)(2)(i).
[8] See Treas. Reg. §1.101-1(b)(1)(i).
[9] Treas. Reg. §1.101-1(c)(1).
[10] Treas. Reg. §1.101-1(d)(4)(ii).
[11] Treas. Reg. §1.101-1(c)(2); Prop. Treas. Reg. §1.101-1((b)(iv).
[12] See Treas. Reg. §1.101-1(e)(3)(ii).
[13] Treas. Reg. §1.101-1(d)(2).
[14] Within the meaning of IRC Sec. 264.
[15] Within the meaning of IRC Sec. 469.
[16] Within the meaning of IRC Sec. 414(q), except that for purposes of this clause (Treas. Reg. §1.101-1(d)(2)(ii)(A)(1) only), "highly compensated employee" does not include former highly compensated employees.
[17] Within the meaning of IRC Sec. 414(q).
[18] Within the meaning of IRC Sec. 101(j)(2)(A(ii)(III).
[19] Treas. Reg. §1.101-1(d)(3).
[20] Treas. Reg. §1.101-1(d)(1).
[21] Treas. Reg. §1.101-1(e)(3)(ii). This value determination is based on the gross assets of the C corporation, and the value of the life insurance policies, for this purpose, can be determined based on the basis of the cash surrender values if the policies have cash values. See Treas. Reg.§1.101-1(f)(4)(iii)(A).
[22] Treas. Reg. §1.101-1(b)(1)(i).
[23] Treas. Reg. §1.101-1(b)(1)((ii)(B)(3).
[24] Treas. Reg. §1.101-1(b)(1)((ii)(B)(2)
[25] Treas. Reg. §1.101-6(b).
[26] Treas. Reg. §1.101-1(c)(2)(iii)(A)

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