Ruling Gives Lessons in Transfer-for-Value Rules*

By Lee Slavutin

In an unusual private letter ruling involving the purchase of options tied to the appreciation in home values, the IRS has recently agreed that sales of membership interests in a limited liability company that owned life insurance policies on the lives of the homeowners did not run afoul of the rules governing transfer-for-value. For his take on this ruling and on the intricacies of the transfer-for-value rules generally, we consulted with Lee Slavutin, MD, CLU, a principal of Stern Slavutin-2 Inc., an insurance and estate planning firm in New York City, and a member of the CCH Financial and Estate Planning Advisory Board.

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Transfer for Value: General Rule and Exceptions

CCH: The transfer-for-value rules are found in Code Sec. 101(a). Could you provide our readers with an overview of those rules and some insight into why they are so important?

Dr. Slavutin: The basic issue is whether life insurance proceeds are includible in income. Under Code Sec. 101(a)(1), proceeds paid on life insurance contracts upon the death of the insured are generally not includible in income. This income tax exemption is lost when a life insurance policy is transferred for valuable consideration.

The rules governing transfer for value can seem deceptively simple at first glance. Code Sec. 101(a)(2) is titled "Transfer for valuable consideration," and begins:

In the case of *a transfer for a valuable consideration* (emphasis added), by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

In other words, if a life insurance policy is transferred to someone or some entity in exchange for something of value, then the death benefit, less consideration and premiums paid, will be includible in the beneficiary's gross income.

There are a number of *exceptions* to the general transfer-for-value rule. One set of exceptions is based on the identity of the transferee. These exceptions cover a transfer to (1) the insured, (2) a partner of the insured, (3) a partnership in which the insured is a partner, or (4) a corporation in which the insured is a shareholder or officer. This group also includes an exception not found in the Code, but one sanctioned in Rev. Rul. 2007-13, IRB 2007-11, 684, and that is a transfer to a grantor trust, in which the grantor is

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the insured (see CCH Estate Planning Review, March 20, 2007, story 1).

However, as usual, the devil is in the details. In that regard, note that there are some significant omissions from this list of exceptions. Unlike a transfer to a partner, there is no exception for a transfer to a co-shareholder. There is also no mention of a transfer to a limited liability company (LLC), even though an LLC is very similar to a partnership for tax purposes. It is likely that a transfer of a policy to an LLC will be treated as a transfer to a partnership by the IRS (for the purposes of the transfer-for-value rule), but to be certain of this result the client will have to obtain a private letter ruling (IRS Letter Rulings 9625013-019, 9525022, and 9525023 ruled favorably on this question).

A second set of exceptions covers cases where the insurance contract or interest therein has a basis for purposes of determining gain or loss in the hands of the transferee that is determined by reference to its basis in the hands of the transferor —in other words —a carryover basis. This category includes (1) a gift (Code Sec. 1015), (2) a transfer pursuant to a divorce agreement (Code Sec. 1041(b)), and (3) certain tax-free reorganizations (Code Sec. 358).

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Transfer for Value: Examples

CCH: Could you describe some examples when the transfer-for-value rules can present a problem?

Dr. Slavutin: One common example involves a *buy-sell agreement*. For example, if a C corporation owns policies on two shareholders, A and B, this could create an alternative minimum tax (AMT) problem because insurance proceeds received by a corporation are excludable for regular income tax purposes, but not for AMT purposes. Consequently, the parties may wish to transfer the policies from the corporation to the shareholders —effectively going from a redemption type buy-sell agreement to a cross purchase, to avoid the AMT. The corporation would transfer the policy on the life of Shareholder A to Shareholder B and the policy on Shareholder B to Shareholder A.

In J.R. Monroe v. Patterson, 61-2 USTC ¶9555, 197 FSupp 146, the court ruled that the transfers described above would trigger transfer for value. Valuable consideration received when a policy is transferred does not have to be cash. It could take the form of a relief of an obligation, such as the corporation's obligation to pay future premiums and to redeem the stock from the estate of the deceased shareholder. And, the transaction described above would not qualify for an exception to transfer for value, because, as I mentioned earlier, a transfer to a co-shareholder is not an exception. Thankfully, there are ways to avoid this result, for example if the shareholders were partners in a separate existing partnership. The parties could also establish a new separate partnership to hold the life insurance policies, but the IRS will not rule as to whether a partnership formed principally to hold life insurance will satisfy the exception to transfer for value (see Rev. Proc. 2008-3, IRB 2008-1, 110, Section 3.01(8)). Consequently, lawyers usually recommend that clients establish the partnership for some other business or investment purpose.

A second example is an *intra-family transfer* of a life insurance policy. For example, a father owns a policy on his life with his wife and daughter as beneficiaries. If he decides to give the policy to his daughter in a pure gift transaction, this would clearly be covered by an exception to the transfer-for-value rules. However, because it would be a gift for gift tax purposes and, depending on the exact value transferred, it could use up a major portion of the father's $ 1 million lifetime gift tax exclusion, he may want to reduce the amount of the gift. So, if instead, the father takes out a loan against the policy prior to gifting it, this will reduce the amount of the gift, but could have the unintended result of tripping the transfer-for-value rules. Relieving the father of the obligation to repay the policy loan (after the policy is assigned to the daughter) is treated as valuable consideration. If the father's basis in the policy is less than the amount of the loan he will have income in the amount of the debt forgiven minus his basis in the policy. The transfer of the policy for valuable consideration (forgiveness of the loan) will also cause the death benefit to be taxable to the daughter (if the loan exceeds the father's basis; see Rev. Rul. 69-187, 1969-1 CB 45; Reg. §1015-4(a) and IRS Letter Ruling 8951056). The daughter will have to report the death benefit, less the amount of the loan and any premiums she paid, as income.

Finally, there is the case of a *life settlement*, part of a growing portion of the life insurance industry. Whenever a policy is sold to a third-party institutional investor, that investor will have to pick up the death benefit on that policy as income. Investors recognize this and they factor the tax ramifications into the purchase of the policy.

IRS Letter Ruling 200826009

CCH: Recently the IRS released Letter Ruling 200826009 which presents a transfer-for-value question. Could you give our readers a synopsis of this private letter ruling?

Dr. Slavutin: The facts of the ruling are somewhat unusual. At the heart of the ruling is a program whereby an LLC that is operating as a partnership for tax purposes buys an option on an individual's personal residence. The option allows the LLC to share in a portion of the future appreciation, if any, in the value of the residence. Specifically, the LLC would purchase call options from homeowners (based on certain age and life expectancy criteria) with respect to their personal residences. Each option would include an option premium (based on a certain percentage of the current present value of the personal residence) for the LLC to acquire the owner's home (upon the occurrence of certain events) at a strike price equal to the fair market value of the home, plus a specified percentage of any subsequent appreciation in the home, and minus an acquisition cost charge that is capped at a specified percentage of the fair market value of the home at the time the option is exercised (see example below).

Under the agreement, the LLC would then make either an initial lump-sum premium payment or monthly payments to each of the homeowners until the earlier of (i) the time of the homeowner's death or (ii) the sale of the residence. Upon the occurrence of either (i) or (ii), the option would become immediately exercisable. Of course, if the personal residence has substantially depreciated in value during the course of the transaction, the LLC would not purchase the home.

CCH: How does life insurance fit into these arrangements?

Dr. Slavutin: These transactions involve an element of risk —namely, the possibility that the homeowner dies before any significant appreciation in the value of the personal residence occurs. Part of the transaction therefore involves the purchase by the LLC of a life insurance policy from a commercial insurer on each individual homeowner with the LLC named as the owner and beneficiary of the policy. For example, if the homeowner were to die only a year or so after the option was acquired, the option would presumably have no value because the likelihood is that there would be no appreciation in the value of the home. However, the life insurance policy would have value in such a case and the policy would provide liquidity for the exercise of other options under the program. All premium payments and costs incurred in creating and maintaining the policies would be paid by the LLC and, upon the death of a homeowner, payments pursuant to the policy would be made directly to the LLC as beneficiary. If, for some reason, a homeowner is not able to qualify for insurance on his or her life, the homeowner would not qualify for the program.

The following example, based on the facts presented in the letter ruling, illustrates these points.

Example. A home has a fair market value of $750,000 at the time that the LLC purchases the option to acquire the home at a formula based strike price when the homeowner dies. The LLC pays the homeowner 15 percent of the fair market value, or $112,000, for that option. The LLC secures a life insurance policy on the homeowner's life in the face amount of $1,500,000. Under the option agreement, the LLC and the homeowner share equally in the future appreciation of the home. Over a 10-year period, the home increases in value to $1,400,000. If the homeowner dies at the end of 10 years, the LLC will pay the homeowner's estate a strike price of $963,000 ($750,000 initial value + $213,000 [the homeowner's equal share of the appreciation during the 10-year period of $325,000, minus the acquisition cost of $112,000]). A portion of the life insurance proceeds that the LLC receives at the homeowner's death may be used to fund the payment of the strike price.

The LLC has made a profit equal to its share in the appreciation in the property, plus whatever profit element is left from the insurance proceeds over and above the premiums paid during the 10-year period.

CCH: What about this program triggered the inquiry on ***transfer for value***?

Dr. Slavutin: That question involved an additional element of the program. Once the LLC was fully funded —in other words —when all of the options and life insurance policies were acquired, membership interests in the LLC would be sold to third-party investors for cash. The LLC operating agreement contained restrictions on transferability that were designed to avoid a termination of the LLC under Code Sec. 708(b)(1)(B) (i.e., no sales or exchanges of 50 percent or more of the total interest in partnership capital and profits within a 12-month period).

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The LLC would then either hold the options until they are exercised or lapse, or sell them to institutional investors in the market. Upon the exercise of an option, the LLC would sell the related home as soon as possible and distribute the proceeds from the return on the option to the investors in accordance with their member interests. Similarly, once the life insurance proceeds were paid by the insurer, the LLC would distribute the proceeds to investors in accordance with their respective LLC membership interests.

After reviewing the details of the program, the IRS concluded that, the sale or exchange of membership interests in the LLC was not equivalent to a sale of the life insurance policies and, thus, would not result in a transfer for valuable consideration under Code Sec. 101(a)(2), provided there is no termination of the partnership under Code Sec. 708(b)(1)(B).

Insurable Interest

CCH: What about the question of whether the LLC had an insurable interest in the lives of the homeowners?

Dr. Slavutin: That issue was not a point of contention in the ruling because the LLC represented that it had a valid insurable interest in each insured individual under applicable state law. However, the issue of insurable interest can certainly come up in similar transactions. For example, we recently encountered the issue with a client who is a money manager. An outside investor wanted to acquire an interest in the money management firm. As part of the transaction, the investor wanted to insure the key managers. Many insurance companies were hesitant to issue life insurance for this purpose, because it was the outside investor rather than the operating company that was seeking the insurance. The insurers were simply not comfortable with protecting an investment as opposed to traditional key-man insurance (which is owned by the operating company).

One could argue that the investor had an insurable interest because she was making a substantial investment in the company and, if one or more of the key managers were to die, the company could fail and the investor could lose her money. However, it is certainly a step beyond typical key-man insurance. In our case, we were ultimately able to find an insurance company willing to issue insurance under these circumstances.

Conclusion

CCH: Could you please sum up for our readers?

Dr. Slavutin: Every client expects their life insurance benefit to be free of income tax. Transfer for value must be avoided. The practitioner should advise any client contemplating the transfer or assignment of a life insurance policy to put the transaction on "PAUSE," and allow the advisor to check the rules and see if there is any disguised consideration. Also, remember that any transfer for value can be "cured" by transferring the policy back to the insured. The last transfer is the one that counts.

Endnotes

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