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Transfer-for-Value & Reportable Policy Sale Concerns in Buy-Sell Arrangements

Situation: Using life insurance as a funding vehicle for a buy-sell arrangement gives rise to several potential tax traps, especially in out-of-the-ordinary owner/beneficiary structures. It seems that more than almost any other area, buy-sell agreement funding, modification, and termination gives rise to potential transfer-for-value and reportable policy sale traps. This *Counselor’s Corner* discusses some of the most frequent buy-sell situations that result in adverse taxation under these rules.

Solution: Before discussing the potential tax traps caused by life insurance transactions in buy-sell arrangements, let’s first review how the transfer-for-value and the reportable policy sale rules work and why violation of these rules can be so detrimental to a buy-sell situation.

Life insurance proceeds are generally excluded from the income of the beneficiary, even if the policy is used to fund a buy-sell agreement and even if the buyer uses the proceeds to complete the buyout.[1] However, IRC § 101(a) provides that part of the death benefit proceeds under a policy ***transferred for valuable consideration*** will be taxed as ordinary income – unless the transfer falls within an exception to this general rule. Death benefit proceeds from life insurance policies transferred for valuable consideration are generally income taxable to the extent that the proceeds exceed the policy owner’s cost basis (basis). Both permanent and term life insurance policies are subject to the transfer-for-value rule.

Consideration is defined broadly and does not need to be cash or property. A mutual or reciprocal promise can trigger the transfer-for-value rule.[2] Herein lies the problem for many buy-sell scenarios. Fortunately, death benefit proceeds will not be subject to taxation under the transfer-for-value rule where the transfers are made to the following exempt transferees:

1. The insured,
2. A partner of the insured,
3. A partnership in which the insured is a partner,
4. A corporation in which the insured is an officer, or shareholder, or
5. Any person where the transferee’s basis in the policy is determined in whole or part by reference to the basis of the transferor (i.e., carryover basis transferees).

In addition to the above, the Tax Cuts and Jobs Act of 2017 added IRC Section 101(a)(3), introducing ***reportable policy sales*** rules, generally designed to address the commercial transfers of life policies (i.e., life settlement transactions). Violation of the reportable policy sales rules also affect the portion of the policy death benefit that may be subject to income taxation. Unfortunately, the transfer of a policy interest may constitute a reportable policy sale even though the individual or entity receiving the policy falls under one of the exceptions of the transfer-for-value rule. Furthermore, the reportable policy sale rule imposes a reporting requirement on a taxpayer who acquires a policy in such a transfer, as well as on the transferor, the issuing insurer and any party making payments of death benefit with respect to the policy transferred.

A reportable policy sale is defined as the acquisition of a life policy, directly or indirectly, in cases where the acquirer has no substantial family, business, or financial relationship with the insured independent of the acquirer’s interest in the life insurance policy being transferred[3]. It’s worth noting that a reportable policy sale does not require a sale of the policy, but the mere acquisition of the policy; including gratuitous transfers where the donee lacks a substantial relationship (family, business or financial) with the insured. The reportable policy sales provisions are effective for reportable sales entered into and death benefit received after December, 31, 2017.

When a policy is acquired as part of a reportable policy sale, none of the transfer for value exceptions discussed above are available. The only way to cure a reportable policy sale is by transferring the policy to the insured for full and adequate consideration. Like the transfer-for-value rule, the reportable policy sale regulations describe several exceptions to the rule. The following are not considered reportable policy sales[4]:

1. Transfers between entities with the same beneficial owners if the ownership interests of each beneficial owner in both the transferring entity and the transferee entity do not vary by more than 20%;

2. Transfers between corporations that are members of an affiliated group (regulation defined) that files a consolidated income tax return in the year transfer is made;

3. Person acquires ownership interest in a partnership/trust or other entity (directly or indirectly) that owns a life policy if the entity acquired the interest in the policy (i) before January 1, 2019 or (ii) in a reportable policy sale and complied with the requirements for such sales;

4. Immediately before person acquires an interest in a partnership/trust the entity owning an interest in the life policy:
   - No more than 50% of the gross value held by the partnership/trust/entity consist of life insurance contracts, and

   - Following the acquisition, the person acquiring the interest in the partnership/trust/entity and his/her family members own, in the aggregate:

     » For S corporations: 5% or less of total combined voting power of all voting stock and 5% or less of the total value of shares of all classes of stock

     » For trust/estate: 5% or less of the corpus and 5% or less of annual income

     » For partnership: 5% or less of capital interest and 5% or less of profits interest

5. Person acquires ownership interest in a C corporation and 50% or less of the gross value of the assets of the C corporation consist of life insurance contract immediately before person acquires its interest;

6. Acquisition of a life contract by an insurance company that issues life insurance contracts in an exchange pursuant to §1035 exchange;

7. Acquisition of a policy in a §1035 exchange if the policy holder has a substantial family, business, or financial relationship with the insured at the time of the exchange.

Clearly, the transfer-for-value and reportable policy sale rules need to be avoided in a buy-sell arrangement. The unexpected taxation of a large lump-sum payment of policy proceeds raises financing problems for the buy-sell arrangement. If only the after-tax proceeds are available to buy the deceased's business interest, under-funding of the purchase obligation may result, and the buyer may not be able to affect the purchase for cash or may be forced to seek funds elsewhere.

Following are several common situations that often give rise to transfer-for-value and reportable policy sale problems in buy-sell arrangements:

Shifting Policy Ownership. Circumstances change and business owners may discover that the original structure of their buy-sell was not the best strategy, so they restructure it, changing from a stock redemption to a cross purchase or vice versa. If a wait-and-see buy-sell is used, when the ultimate decision is made as to who will be the buyer (entity vs. individual), policies may have to be shifted to place the financing where it is needed to affect the buyout. When the ownership on existing policies is shifted to accommodate a change in the form of a buy-sell agreement, beware of transfer-for-value and reportable policy sale problems.

For example, suppose that ABC, Inc. (an S corporation) owns a $2 million life insurance policy on each of two stockholders. The policies fund a stock redemption agreement. The stockholders decide to end this agreement and to fund a new cross purchase agreement. To fund the new agreement, owner "A" intends to buy the policy on owner "B's" life from ABC, Inc. and owner "B" will buy the policy on "A." Without knowing more, it appears that a transfer from a corporation to co-shareholders does not fit into one of the exceptions to the transfer-for-value rule and may also be a reportable policy sale.

One solution: The corporation can retain the policies, using the coverage to provide key person protection, and "A" and "B" can purchase new policies on each other.

Another solution: A and B can purchase their own policies from the corporation and use the coverage for personal insurance needs. This transaction will preserve the tax-exempt status of life insurance proceeds because a transfer to the insured is an exception for the transfer-for-value rule and is a substantial family relationship for the reportable policy sale rule, but once again new policies need to be acquired to provide coverage for the buy-sell arrangement.

Third possibility: If "A" and "B" are also partners in a bona fide partnership when the policies are transferred from ABC, Inc. to the co-shareholders, the transfer would qualify for the transfer-for-value exemption for a transfer to a partner. However, the regulations specifically provide that the sole fact that an acquirer is a partner of the insured or a partnership in which the insured is a partner is not sufficient to establish a substantial business or financial relationship with the insured for purposes of the reportable policy sale rule. In this regards the regulations provide that a substantial financial relationship exists between the insured and the acquirer if they have a common investment (other than the interest in the life insurance) and a buy-out of the insured's interest in the common investment after the insured's death is reasonably foreseeable. Presumably, an existing buy-sell agreement, or other documentation with buy-out provisions, will be sufficient to prove reasonable expectation of a buy-out.

When shifting policies from individual ownership to corporate ownership, transfer-for-value issues are avoided if the insured is a shareholder or officer in the corporation – another transfer-for-value exemption. However, again the regulations provide that the sole fact an insured is an officer/shareholder is not sufficient to avoid the reportable policy sale rules; there must also be either a substantial business or financial relationship. In this regard the regulations provide that a substantial financial relationship exists between and insured and the acquirer where the acquirer maintains the life insurance to provide funds to satisfy liabilities arising by reason of the death of the insured.

Using Existing Policies to Fund a Cross Purchase Agreement. Often, when business owners want to create a cross purchase buy-sell, they attempt to use existing policies as the financing vehicle perhaps because of a business owner's adverse health. This might not be the best decision, as the Internal Revenue Service (IRS), relying on the Internal Revenue Code's (IRC) broad definition of "value," has repeatedly taken the position that reciprocal promises under a buy-sell arrangement is "consideration."

For example, in *Monroe v. Patterson*, where a corporate-owned policy was transferred to a trust established to administer a cross purchase buy-sell and the shareholders were required to pay continuing premiums on the policy, the U.S. district court held that there had been a transfer-for-value.[5] Here, the court found two forms of consideration: the mutuality of the agreed upon obligations (the agreement to buy) and the actual cash consideration paid (as premiums) by the surviving beneficiary shareholder.

In *Private Letter Ruling (PLR) 7734048*, the IRS reached a similar adverse conclusion where policies were simultaneously transferred from the insureds to their co-shareholders to fund a cross purchase arrangement. Here, two shareholders each owned a policy on their own life. After they established a cross purchase agreement, they transferred the policies to each other. At the time of the transfer, the policies were in their first year and had no cash value.

Once again, the IRS held that there was consideration even though no cash changed hands. The reason? The reciprocal transfer of the policies. **Note that it made no difference that the policies had no value at the time of the transfer. Under this reasoning, even if the policies were term policies, they would be subject to the transfer-for-value rule.**

The unwary often suggest that a corporation give a policy to a shareholder to avoid the transfer-for-value rules. However, the IRS is not likely to view this transaction as a gift when done in a business context. Rather, it will be treated as a policy distribution (i.e., as a dividend or as compensation to the receiving shareholder) and the transfer-for-value rule will apply.

It is also unlikely that the transfer-for-value problem can be avoided if the insured buys the policy from the corporation and then gives it to the other shareholder. The IRS could contend that the two transfers should be treated as a single transfer (i.e., a collapsible step transaction). In addition, the IRS might argue that reciprocal promises (promises by each shareholder to acquire the policy on his/her life and then to give it away) create valuable consideration. *See the discussion of the "Estate of Rath v. United States" that follows.*

Death of a Shareholder. In a cross-purchase arrangement, issues may occur where a shareholder dies owning policies on the surviving shareholders and the policies are subsequently sold to co-shareholders who are not the insured because the transfer does not fall within an exception to the transfer-for-value rule. One solution for selling an existing life insurance policy to a co-shareholder who is not the insured is to make certain that the insured and acquirer are also partners in a bona fide partnership and they have a substantial financial relationship as previously discussed.

Other potential solutions: The estate could surrender the policies for cash; or the survivors could buy the policies on their own lives and continue them as personal insurance. Alternatively, the corporation may want to purchase the policies on the surviving shareholders from the estate of the deceased shareholder. The sale meets the transfer-for-value exception since the insureds are shareholders of the corporation. However, if the corporation is not expected to purchase the shareholders interest at his or her death (because the buy-sell is a cross purchase arrangement), then to avoid adverse taxation under the reportable policy sales rule the transfer must meet the substantial business relationship requirements. To meet the substantial business relationship requirements the insureds must be key people as defined by IRC §264 (which requires the insureds to be officers or 20% owners) or materially participate as owners, employees, or contractors in an active trade or business owned directly or indirectly by the acquirer, and at least 80% of the business must be owned directly or indirectly by the acquirer.

Terminating a Buy-Sell Agreement. When a stock redemption agreement is terminated, the corporation may wish to distribute the policies to the respective insureds if the policies are no longer needed for a business purpose. The distribution of a policy to the insured qualifies as one of the five safe harbors for transfer-for-value rule and is a permitted substantial family relationship transfer under the reported policy sale rules.

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The *Estate of Rath v. United States* is a lesson on what not to do.[6] Under the buy-sell agreement, the shareholder-insured had the right to have the policy assigned to himself or his nominee if the corporation decided to terminate the agreement. At the termination of the redemption agreement, the corporation sold the policy to the shareholder's wife.

When the IRS held that there was a transfer-for- value, the wife argued that, in reality, her husband had exercised his option to have the policy transferred to him (a protected party) and then he had given the policy to her (an exception to the transfer-for-value rule). The court ignored the argument that a two-step process had been utilized, holding that the fact that the insured could have acquired the policy himself and then transferred it to his spouse, retaining the exclusion of the proceeds at his death, did not warrant the court recharacterizing what had actually occurred.

It is important to note that even if a taxpayer could convince the IRS that s/he had acquired the policy directly and then transferred it as a gift to a spouse, the risk of estate inclusion of the policy proceeds still exists for three years after the transfer.

In Summary. In any buy-sell scenario, if the needed financing is to be available at the death of the shareholder, care must be taken to be certain that the transfer-for-value and reportable policy sale rules do not apply. Additional scrutiny should be given to any buy-sell scenario where existing policies are brought into the buy-sell or where policy ownership is shifted. It is important to remember that the IRS has viewed the mere presence of reciprocal promises as valuable consideration, resulting in unexpected and unwanted tax results. Many of these situations can be resolved through planned use of the safe-harbor exemptions.

[1] In addition to the transfer for value and reportable policy sale rules, employer-owned life insurance policies issued after August 17, 2006, IRC §101(j) provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally income tax-free under IRC § 101(a).

[2] The pledging or assignment of a policy as collateral security is not a transfer for valuable consideration.

[3] As defined in Treasury Regulations §1.101-1(d) a substantial business relationship between the acquirer and the insured exists in each of the following circumstances:

- The insured is a key person as defined by IRC §264 or materially participates as owner, employee, or contractor in an active trade or business owned directly or indirectly by the acquirer, and at least 80% of the business is owned directly or indirectly by the acquirer or beneficial owners of the acquirer.
- The life insurance policy is owned by a business that is acquired by the acquirer and the acquirer carries on the acquired business or uses a significant portion of the assets in an active trade or business, assuming one of the following additional requirements is met:
  - » The insured, immediately before the acquisition, is an employee of the acquired business; or
  - » Was a director, highly compensated employee, or highly compensated individual and, immediately after the acquisition, the acquirer has an ongoing financial obligation to the insured (e.g., nonqualified deferred compensation, pension, buy-sell, etc.).

A ***substantial financial relationship*** between the acquirer and the insured exists in each of the following:

- Acquirer acquires the insurance to fund the purchase (at the insured's death) of insured's assets, satisfy liabilities, or purchase interests in common investments with acquirer
- Acquirer is a charity to which the insured has been a substantial contributor or volunteer.

A ***substantial family relationship*** includes the followingrelationshiops of the acquirer to the insured: (1) same person (2) spouse including domestic partners and other legal relationships permitted under the state law and former spouses if a transfer is incident to a divorce (3) a parent, grandparent, or great-grandparent or the spouse of such, (4) a lineal descendant of any of the foregoing (1)(2)(3) or the spouse of such lineal descendant, or (5) any lineal descendant of the person described in (4).

[4] The exceptions to the reportable policy sale rules are complex. Clients should consult with their tax advisors prior to the transfer of a life insurance policy or an interest in a partnership, trust, or other entity that owns life insurance.

[5] Monroe v. Patterson, 197 F. Supp. 146 (ND Ala. 1961).

[6] Estate of Rath v. United States, 608 F.2d 254 (6th Cir. 1979)

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