ADVANCED MARKETING
ACTIVATOR
OCTOBER 2004

TRANSFER FOR VALUE: THE THORN IN THE LIFE INSURANCE ROSE

"The failure to recognize a transfer for value could be the single most expensive mistake an insurance professional could make."

IMPORTANCE OF UNDERSTANDING THE RULE

Life insurance is one of the cornerstones of estate planning. Life insurance is, by far, the most efficient vehicle through which the need for cash/liquidity (for personal and/or business reasons) triggered by the insured's death may be met. If the policy ownership and beneficiary designation are arranged properly, life insurance proceeds can be both estate and income tax free - in unlimited amounts. Death benefit well in excess of $100,000,000 could be paid to an individual, trust, or business without triggering either estate or income tax!

Yet a small slip, a common mistake, can cause either the estate or income tax (or both) to apply. As the following chart illustrates, the results of such an error can be devastating since, if life insurance is subject to income tax, it is taxed at ordinary rather than capital gains rates.

DUE TO INCOME TAX ON PROCEEDS (ASSUME DEATH IN 2004)

Amount Taxable	Single	Joint	Trust/Estate	C Corp	Service Corp
$ 100,000	$ 22,627	$ 18,475	$ 34,126	$ 22,250	$ 35,000
$ 500,000	$155,907	$149,643	$174,126	$170,000	$175,000
$1,000,000	$330,908	$324,643	$349,126	$340,000	$350,000

(Figures courtesy of NumberCruncher Software)

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

Prudential Financial

This commentary will focus on the most common, easy to detect, yet potentially expensive of all of these traps, the transfer for value rule. This rule, if invoked, can cause all or a substantial portion of the life insurance to be taxed as ordinary income, rather than income-tax free, to its intended beneficiary(ies).

This commentary will:
1. Explain what the transfer for value rule is,
2. List and explain the exceptions to the rule,
3. Illustrate how it operates in typical real life situations in personal, business, and employee benefit planning.

PARANOIA AS AN OPERATING PRINCIPLE

I strongly suggest planners be vigilant and treat every transfer of a policy or an interest in a policy as a potential transfer for value, until the issue is ruled out by careful examination of all the relevant facts and application of the rules to those facts. All too often, these insidious "transfer for value" traps are not easily spotted. Yet the failure (either by error or omission) to recognize a transfer for value could be the most expensive mistake a planner or practitioner can make.

CODE SECTION 61: WHERE IT ALL STARTS

Code Section 61 is the starting place for understanding the income tax system. It clearly states that

"gross income includes
all income from whatever source derived…"

Therefore, the general rule is that the receipt of income - no matter what it is called or from where it is received - is taxable.

For instance, if you received $1,000,000 in fees, the entire amount would be subject to ordinary income tax rates. The federal income tax would be about $324,643 if you filed jointly and you would net only the difference, about $675,357.

CODE SECTION 101(a): THE EXCEPTION TO THE GENERAL RULE

In one of the few exceptions to the general rule that all income is taxable, Code Section 101(a) provides that

"gross income does not include amounts received under a life insurance contract
if those amounts are paid by reason of the insured's death."

In other words, the death proceeds of life insurance - without limit - and regardless of the identity of the recipient - are income tax free!

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Example: If your surviving spouse, child, trust, or estate received $1,000,000 in life insurance proceeds at your death, the spendable or investable amount would be the entire $1,000,000.

CODE SECTION 101(a)(2): EXCEPTION TO EXCEPTION

There is, however, a further exception to the exception to the general rule that provides,

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

Consequently, if there is a transfer for value, the proceeds are NOT entirely income tax free. The proceeds are generally income taxable - except to the extent of the amount the transferee has paid in money or money's worth for the transfer, plus any premiums or "other amounts" (such as nondeductible interest on policy indebtedness) paid after the transfer.

Example: X transferred a $1,000,000 life insurance policy on his life to Y, his co-shareholder. Y paid $20,000 for the policy and three annual premiums totaling $30,000 before X's death. At X's death, Y would be entitled to receive a total of $50,000 ($20,000 plus $30,000) income-tax free, but would be subjected to income taxation on the entire difference, $950,000!

If the IRS finds there has been a transfer for valuable consideration, there are three likely results:

First, the beneficiary(ies) will be surprised, shocked, and horrified.

Second, the objectives for which the insurance was purchased probably will not be met.

Third, litigation will be brought against the advising professionals (this will certainly include the insurance agent but may also include the client's attorney and/or CPA) who failed to take notice of the problem and suggest corrective action.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

EXCEPTION TO EXCEPTION TO EXCEPTION

Even if there has been a transfer and even if it has been in return for valuable consideration, the policy proceeds will not lose their income-tax-free status if:

1. "Such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or
2. If such transfer is to
    a. the insured,
    b. a partner of the insured,
    c. a partnership in which the insured is a partner, or
    d. a corporation in which the insured is a shareholder or officer."

SUMMARY OF SAFE HARBORS

Transferee	Safe Harbor
Party Whose Basis Determined in Whole or Part by Reference to Transferor's Basis	Applies
Insured	Applies
Partner of Insured	Applies
Partnership in Which Insured is Partner	Applies
Corporation in Which Insured is Officer or Shareholder	Applies
Spouse of Insured	Applies
Ex-Spouse of Insured	May Apply
ANY OTHER PERSON OR ENTITY	SUSPECT A PROBLEM

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

TRANSFER FOR VALUE QUIZ

Use the following questions and answers (and/or comments) to test your knowledge.

Q1: What constitutes a "transfer for value?"

A1: Any transfer of a right to receive all or even a part of the life insurance proceeds in exchange for a valuable consideration is a transfer for value.

Keep in mind that a "transfer" can extend beyond the sale or absolute assignment of a policy (or an interest in a policy). It can occur through the naming of a beneficiary, or by establishing the right to receive all or part of the policy proceeds in a separate agreement (or enforceable contract). Likewise, the term "value" is not limited to cash, but can be in the form of money's worth, or other forms of "payment in kind."

Therefore, the key questions to ask are:

(1) Is there a transfer? And, if so,

(2) Has the transferee paid any type of valuable consideration (in money OR money's worth) for the transfer?

If there is a transfer - even of a mere interest in a policy - and that transfer is precipitated, or accompanied by any type of consideration that has an economic value (or benefit), the trap is set. Of course, it may be possible to undo the trap at any time prior to the insured's death through the use of one or more of the safe harbors.

Q2. Can the transfer for value rule be avoided if the transferor does not actually transfer the contract and sell it outright to the transferee?

A2: No! ANY absolute transfer triggers the trap. No physical transfer of the policy is necessary. Nor is it required that every interest in the policy be transferred for the rule to be invoked. If the right to receive any or all of the economic benefits of a life insurance policy is transferred in return for valuable consideration, that will be sufficient to set the trap. For instance, if Gene makes his brother, Gary, the beneficiary of a policy on Gene's life in return for Gary's transfer of ownership of a car, there has been the requisite transfer.

Similarly, if Gene names Gary beneficiary in return for Gary naming Gene beneficiary of a policy on Gary's life, there has been the requisite consideration. The creation for value of any enforceable contractual right to receive all or a portion of the proceeds will set the trap - even if no physical transfer of the insurance policy was ever made.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Q3. If a policy is transferred, but no consideration (of any economic value) is paid by the transferee, would the income-tax free nature of the proceeds be retained?

A3. Yes. If there is NO consideration given in exchange for the transfer, such as an outright gift of a policy, the proceeds will be income-tax free. Technically, a gift for a nominal promise to pay value (e.g. "FOR ONE DOLLAR") will not trigger the rule because it will be treated as no consideration; however, I strongly recommend against that language. The phrase "FOR LOVE AND AFFECTION, AND NO MONEY OR MONEY'S WORTH" should be used in connection with a transfer of a policy (or an interest therein), if only to remove even the slightest possibility that the IRS would question it.

BEWARE: A quid pro quo ("I will do this for you, if you will do that for me") is consideration just as surely as if money changes hands. There need be nothing in writing or anything specifically stated by the parties involved for there to be a valuable consideration. The IRS will assume that there is consideration given to the transferor, where it is reasonable to believe (or surmise) that, in its absence, the transfer would not have occurred.

Q4. A pledge or assignment of a policy as collateral for a loan/indebtedness will NOT trigger a transfer for value. True or false?

A4. True! Although an absolute assignment WILL set the trap, a collateral assignment will NOT. So it is possible to pledge or assign a life insurance policy (or an interest in a policy) as security for a third-party loan - without endangering the proceeds' income-tax free status.

Q5. A policy with no cash value is not subject to the transfer for value rule. True or false?

A5. False! Even a term insurance policy which does not have, and never will develop, cash value is subject to the rule.

All types of life insurance for either single life or multiple lives (e.g., term, permanent, fixed, universal, adjustable/flexible, or variable, etc.) as well as group life insurance are subject to the transfer for value rule.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Q6. If the transferee has insurable interest in the insured's life, the transfer for value rule is not applicable. Right or wrong?

A6. Wrong! Insurable interest laws deny tax-free treatment of proceeds to those who have no insurable interest in the continued life of an insured. But not all parties who have insurable interest fall within a safe harbor of the transfer for value rule. A mere technical violation of the rule is sufficient to subject the proceeds to income taxation; it may be invoked even if the transferee is not speculating or wagering in any way on the insured's life. So logic is not a good guideline in determining if a given situation falls within the rule. You must pay strict attention to the actual wording of the Internal Revenue Code as quoted above.

Q7. A transfer of a policy where the transferee's basis is determined in whole or in part by reference to the transferor's basis will fall within a safe harbor exception to the transfer for value rule. Right or wrong?

A7. Right. This so-called "basis carryover exception" is the first of five safe harbors that protects the tax-free status of policy proceeds - even if there HAS BEEN a transfer for valuable consideration. It essentially says that where the transferee is required by tax law to carry over all or a portion of the transferor's (e.g., a donor's) basis, the death proceeds will remain income-tax free. So outright gifts of life insurance, such as gifts for LOVE AND AFFECTION, are safe from application of the rule, provided no consideration of ANY kind changes hands in return for the transfer.

Likewise, this carryover of the transferor's basis may protect a transfer in a business context. For example, if there is a tax-free reorganization and a business transfers a policy it owns on the life of an officer, a shareholder, or even an employee, to another corporation as part of the reorganization, the successor corporation will carry over the basis of the transferor corporation, and the proceeds of the policy will be excluded from income when the insured dies. (However, note that corporate AMT may apply.)

Q8. Bill transfers a policy with a large loan against it to his irrevocable trust, but receives nothing in return from the trustee for the transfer. Will such a transfer be considered a transfer for value?

A8. The IRS might treat the transfer of a policy subject to a loan as a transfer for value. The rationale is that the trust is, in essence, relieving Bill of the obligation to repay the loan. Although no actual payment has been made, the trustee's acceptance of the policy is tantamount to the trustee's paying Bill an amount equal to the outstanding loan. Furthermore, this transaction might trigger income taxation to Bill, if the policy value exceeds his cost basis as of the date of the transfer.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

So I generally advise against transferring a life insurance policy when it is subject to a loan in excess of the transferor's basis. To be safe, be sure the transferor's basis is significantly greater than the loan, so the transferee will be able to take a basis in the policy determined by reference to the transferor's basis.

BEWARE: If the policy owner borrows heavily against the policy prior to transferring it, and the loan exceeds the policy owner's basis, there may be no protection against the transfer for value rule.

Q9. A mother sells her son a $100,000 policy on her life for $1,000. At the time of the sale, the policy had a gift tax value of $4,000 and the mother had paid net premiums of $5,000. This is a transfer for value, but would it fall within the "carryover basis" safe harbor to the rule?

A9. This is a "part gift part sale" situation: There has been a gift of $3,000 (the difference between the $4,000 value of the policy and $1,000 paid by the son), and a sale for $1,000 of a policy worth $4,000. In this example, the transaction will be within the "carryover basis" exception, because the mother's $5,000 basis was greater than the $1,000 she received (so there was no gain or adjustment to her basis), and the gift value is greater than the consideration.

Where the transferor's basis is GREATER than the consideration received, the transferee carries over the transferor's basis. Here, the son's basis (for purposes of determining gain or loss on subsequent policy transactions) will be the basis he can carry over from that of his mother's, i.e., $5,000. So, in spite of the valuable consideration paid by the son, he will receive the proceeds income-tax free.

BEWARE: Be very cautious where there is both a gift and a sale in the same transfer. Under the specifics of the example, if the amount paid by the transferee is greater than the transferor's basis, (i.e., a GAIN to the transferor), there would be a taxable gain and the sale portion of the "part gift part sale" transaction would be greater than the gift portion. In that case, the transaction would be treated as a sale rather than as a gift. Basis is then determined - not by the transferor's basis - but by the amount paid for the insurance contract (or an interest in it).

What is the bottom line? There is NO exemption and the transfer for value time bomb would be ticking. Let me restate this because it is such a complex and deadly rule: If the transferee's basis is determined by the amount the transferee paid rather than a carryover of the transferor's basis, the transaction will be outside the protective safe harbor.

Also, the "basis carryover exception" may not be available even if a transfer is intended as an outright "gift." This can happen if the policy is subject to a loan in excess of the policy owner/transferor's basis at the time of the transfer (see discussion in Q&A 8 above).

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Q10. Rob and Charlee Sterling are husband and wife. Rob transfers a policy on his life to Charlee in return for her payment to him of an amount equal to the policy's gift tax value. Will the proceeds be income taxable?

A10. Although there has been a transfer for valuable consideration, transfers between spouses (and in some cases ex-spouses as well) are income-tax free, i.e., the spouses are treated as the same tax unit. So, no gain or loss is recognized on transactions between them and the recipient spouse carries over the transferring spouse's basis. For income tax purposes the transfer is treated as if it were a gift and, in this example, Rob would have no gain and because Charlee's basis would be determined by Rob's basis (she carries over his basis), it falls within the basis exception to the transfer for value rule.

BEWARE: This special protection does NOT apply to nonresident alien spouses, or nonresident alien ex-spouses, or engaged individuals.

Q11. John names his friend Mary as beneficiary of a policy with no cash value on the last day of a premium payment period (so there is no unearned premium either) in return for her payment of $1,000. This transaction is not subject to the transfer for value rule. Right or wrong?

A11. Wrong! As noted above, policies with no cash value (even term insurance), and policies with no unearned premium are NOT exempted from the transfer for value rule. ANY transfer of a policy or an interest in a policy can trigger the rule. When the proceeds are received by Mary, they will be taxable to her as ordinary income - to the extent they exceed her payment $1,000 plus the premiums paid after the transfer.

Q12. Ross Watson buys a 10-year-old $1,000,000 policy on his life from Mike Bove, his brother-in- law and former business associate in return for its $140,000 gift tax value. Ross names his wife Anne as beneficiary of the policy. Will Anne receive the proceeds income-tax free?

A12. Transfer of a policy TO the insured will ALWAYS be a safe transfer even if consideration is paid for the transfer. Therefore, the proceeds will remain income-tax free to Anne.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Q13. Bob LeClair and Steve Leimberg are partners in a partnership. Steve sells Bob a $4,000,000 policy on his life for its gift tax value, $350,000. Bob's receipt of policy proceeds will be income-tax free. True or false?

A13. True. Transfer of a policy to a partner of the insured is one of the exceptions to the transfer for value rule - even if the transferee partner owns a relatively small interest in the partnership. However, the transferee (or purchaser) must own a bona fide interest, and the partnership itself must be viable and operating entity, i.e., it must meet state law and have a genuine business/investment purpose.

Note that the policy itself does not necessarily have to have a connection with the partnership to be within the safe harbor. For example, policies owned by a corporation on its shareholders, who are also partners in an unrelated real estate investment partnership, can be transferred to the insured's co-shareholder (and partner) and qualify for the exception to the transfer for value rule.

In fact, if one trust sells a policy it owns on the insured grantor to a second trust, but if the insured and the transferee trust are partners in a legitimate partnership (or an LLC taxed as a partnership), the transaction would fall within the "transfers to a partner of the insured" exception. The exception does not distinguish between general and limited partnerships, or between public and private partnerships. So, as long as the insured and the transferee are partners, it appears that a transfer would fall within this safe harbor.

Q14. If one partner who owns life insurance on his life (on that of his partner) sells the policy to the partnership in which the insured is a partner, the transfer will fall within an exception to the transfer for value tax trap. Right or wrong?

A14. Right. A transfer of a policy to a partnership in which the insured is a partner falls within a safe harbor to the transfer for value rule.

BEWARE: It is doubtful that a partnership (or an LLC electing to be taxed as a partnership) created solely for the purpose of evading the transfer for value rule would provide the hoped-for protection. The entity (be it a partnership or an LLC) must withstand scrutiny, that is, it must be a viable, operating entity that meets both state and federal requirements - in both form and substance. So in my opinion, if a partnership's (or an LLC's) ONLY reason for existence is to hold the transferred life insurance, and serves no other legitimate business or investment purposes, it is not likely to provide protection against the transfer for value rule.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Q15. If an existing policy is sold to a corporation in which the insured is president of the corporation, will the proceeds be income tax free (absent corporate AMT)?

A15. Yes. A transfer of a policy to a corporation - in which the insured is either an officer OR a shareholder - falls within a safe harbor exception to the transfer for value rule. Note that it is not required that the transferor be an officer or shareholder. It is only required that the insured be an officer or shareholder.

BEWARE: This safe harbor exception does NOT apply to transfers to corporations in which the insured is not an officer or shareholder, and is only an employee or director. Nor does it apply if the insured is an officer in name only - with no real executive level duties or authority. It is also doubtful if the exception would apply if a shareholder is a nominal owner (e.g., who holds the stock for the beneficial interest of others). However, if the insured is the owner of only a few shares of stock, but the stock is legitimately owned by the insured, the policy may be transferred to the corporation and the safe harbor should be met.

Furthermore, this safe harbor does NOT apply to transfers of corporate-owned life insurance policies to any officers or shareholders other than the insured (unless the transferee is a partner of the insured). Likewise, an estate's sale of life insurance it owns on a surviving shareholder (of the deceased shareholder) to the co-shareholder(s) of that insured individual will NOT fall within a safe harbor exception.

Q16. If a corporate-owned policy is transferred to fund a cross-purchase arrangement, will the transfer for value rule be violated?

A16. In one of the leading cases (determining what is: a "transfer for value" of a policy), the Service held and the court agreed that the mutuality of obligations and the payment by the transferees (through a trustee) of the premiums constituted consideration. The court noted that the transferees (buyers under a stock buy-out arrangement with the insured shareholder) were obligated to make premium payments on the policy and use the proceeds to purchase the stock at the insured's death; and thus relieved the transferor corporation of its obligations and that relief constituted consideration.

BEWARE: Reciprocity - "you do this for me and I will do the same for you," or, "you agree to NOT do this and I will agree NOT to do that" - is consideration that can trigger the transfer for value trap. For instance, two shareholder employees are each insured under group term life insurance. If each agrees to name the other as beneficiary of the coverage to fund a buy-sell agreement, the reciprocity coupled with their transfer of an interest in the group life insurance will trip the transfer for value trap.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Q17. A transfer to a co-shareholder of the insured falls within a safe harbor to the transfer for value rule. Right or wrong?

A17. Wrong! Although it may not make sense nor sound logical, as I have noted above, a transfer to a co-shareholder of the insured is NOT within a safe harbor - whereas, a transfer to a partner of the insured IS!

This reinforces my point that you must go back to the books and check the specific wording of the Code when dealing with issues of policy ownership and/or beneficiary designation, rather than relying on logic or memory to determine whether a given transaction will or will not fall within the rule, and/or if a safe harbor exception applies.

BEWARE: This transfer for value trap occurs most frequently in cross-purchase buy-sell arrangements funded with life insurance and there are multiple (three or more) shareholders. As I mentioned above, the sale by a deceased shareholder's estate of a policy (or an interest in a policy) to the surviving co-shareholder(s) of the insured will subject the proceeds to income tax - unless the transferee is an exempt party.

Some commentators suggest the use of a trusteed cross-purchase buy-sell arrangement to circumvent the need for multiple policies and/or transfers upon the death of one of the shareholders. However, the transfer for value problem cannot be avoided if the shareholders to the arrangement are the beneficial owners of the policies, and the trustee is only a nominal owner.

What are the alternatives? Plan ahead! For instance, determine if the parties to the arrangement are partners in a legitimate partnership (or members of an LLC taxed as a partnership), if not, would it make economic sense to establish such an entity? Would it be feasible to change the existing cross-purchase to a “Wait-and-See” buy-sell arrangement? If so, the deceased shareholder's interests in the policies on the surviving shareholders may be transferred to the corporation for use to effect part of the “wait-and-see” buy-sell.

Q18. Cash or money must change hands before there is the requisite consideration to set the transfer for value trap. True or false?

A18. False! The transfer for value rule may apply even if NO cash or money changes hands. For instance, Doug and Jennie are unrelated co-shareholders and each owns a policy on his/her own life. They switch policies to fund a cross-purchase buy-sell agreement, so that Doug owns, and is the beneficiary of, the policy on Jennie's life and vice versa. Their reciprocal actions (rather than for love and affection and detached generosity) prompted the transfers.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

That reciprocity constitutes valuable consideration. This trap cannot be avoided if, instead of transferring the ownership, they merely name each other the beneficiary of their respective policies.

Q19. If a corporation buys the assets of another corporation and those assets include a life insurance contract on the life of an employee, will the life insurance proceeds be subject to income tax under the transfer for value rule?

A19. The purchase of corporate assets by another corporation is not a tax-free reorganization. Therefore, the purchase of a corporate-owned life insurance policy on an employee by another corporation does not qualify for the "basis carryover exception" as it does under a tax-free reorganization. (See discussion in Q&A 7.) The proceeds will be income taxable - to the extent they exceed the purchase price for the policy, plus premiums and other amounts the new corporation pays after the purchase.

However, if the insured is either an officer or a shareholder of the new corporation, then the transfer would be within the "transfer to a corporation exception," and the proceeds will retain their income-tax free status. (See discussion in Q&A 15.)

Q20. Will the proceeds be tax-exempt if a qualified retirement plan sells or distributes a policy to the insured participant, or his/her beneficiary? Will the proceeds be income taxable if an existing policy is transferred TO a qualified retirement plan?

A20. The purchase of life insurance from a pension or profit-sharing or ESOP is a change in the beneficial interest in the policy and is not exempt from the transfer for value rule. Therefore, the proceeds will be income taxable - unless the transferee is an exempt party to the rule. For example, a sale to a plan participant's irrevocable trust, unless treated as a sale to a grantor trust (i.e. a sale to the insured), would trigger the trap. (Note that not every life insurance trust is a grantor trust. Be very careful and, if and when in doubt, apply for a private letter ruling.)

An existing policy may be contributed to a qualified plan by the participating employee, or it may be purchased by the employer from the employee for contribution to the plan. Since the qualified requirement plan is a tax-exempt entity, even if there is a transfer for valuable consideration, the proceeds will not be taxable to the plan when received.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

CONCLUSION

LEIMBERG'S FIRST LAW OF PLANNING IS:
THE LAST THING YOU WANT TO DO IS MAKE YOUR CLIENT FAMOUS!

BE CAREFUL OUT THERE!! BE SUSPICOUS OF ANY TRANSFER OF A LIFE INSURANCE POLICY (OR AN INTEREST IN A POLICY) FOR POTENTIAL TAX TRAP(S). JUST BECAUSE YOU ARE PARANOID DOESN'T MEAN THIS INSIDIOUS TRANSFER FOR VALUE RULE IS NOT OUT TO GET YOU!

This material is for internal use only and is provided courtesy of The Prudential Insurance Company of America, Newark, NJ. The discussion of planning techniques does not imply that a recommendation that a specific planning concept should be implemented. References to legal and tax considerations are made but are not meant to provide advice in this regard. Please remind clients that legal and tax advice, including the preparation of legal and tax documents, should come from an attorney and/or a tax advisor such as an accountant. These advisors can determine how best to utilize such product or technique.

Prudential Financial Planners can prepare financial plans incorporating many of the planning techniques discussed above. Financial Services Associates and producers can work as knowledgeable members of clients' professional teams to provide suitable products.

Investment advisory services offered through Prudential Financial Planning Services, a division of Pruco Securities, LLC.

Stephan R. Leimburg is not affiliated with Prudential and Prudential makes no representation as to the accuracy of the cites.

COPYRIGHT © 2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial