MassMutual
Strategic Distributors

Understanding the Income Taxation of Life Insurance

Answers to frequently asked questions

General Questions

Income Taxation of Life Insurance

This reference guide is intended to answer some common questions associated with life insurance taxation.

Important: The following answers are general in nature and are for illustrative purposes only. The information provided is not written or intended as specific tax or legal advice. Massachusetts Mutual Life Insurance Company (MassMutual®), its subsidiaries, employees, and representatives are not authorized to give tax or legal advice. Tax law is highly specific to particular facts and circumstances. Individuals are encouraged to seek advice from their own tax or legal counsel.

1 | Do beneficiaries pay income taxes on the death benefit received?

Generally, life insurance proceeds paid upon the insured's death are not included in the beneficiaries' taxable income. Two primary exceptions are:

1. Transfers-for-value (see question 37).
2. Employer-owned life insurance (see question 25).

Note: A life insurance death benefit typically includes interest calculated from the date of the insured's death to the date the insurance company sends the death benefit check to the beneficiary. This interest is taxable to the beneficiary, and the insurance company reports the interest to the Internal Revenue Service (IRS).

2 | Are premiums deductible?

Generally, no. The Internal Revenue Code (IRC) provides that if the taxpayer is directly or indirectly a beneficiary of a policy, premiums are not deductible. Consult your tax advisor to confirm if premiums are tax-deductible.

3 | Do policyowners have to pay taxes on each year's cash value increase?

No. Life insurance policy values increase on a tax-deferred basis.

4 | What qualifies as life insurance for federal tax purposes?

The IRC defines life insurance in IRC § 7702. There are two alternative tests, the Cash Value Accumulation Test (CVAT) and the Guideline Premium Test (GPT). Respectively, the tests limit how much cash value can be accumulated or how much premium can be paid in relation to the policy death benefit, taking into account the insured's age and gender.

MassMutual monitors the limit to ensure the policy does not lose its qualification as life insurance. Premiums exceeding the limit may be rejected. In addition, certain policy changes that cause a recalculation of the limits may force funds out of the policy.

5 | Are all life insurance policies treated the same for income tax purposes?

No, if the total amount of premium paid into a policy exceeds a certain limit, the policy will be classified as a Modified Endowment Contract (MEC). A MEC receives less-favorable tax treatment than a non-MEC policy.[1] MEC policies are addressed separately in questions 18-23. The taxation of non-MEC policies is discussed in questions 13-17.

[1] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty if the policyowner is under 59½.
Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

6 | What is the cost basis of a life insurance policy?

A policy's cost basis represents the owners' investment in the policy. Generally, the net out-of-pocket premium payments increase the cost basis, and non-taxable withdrawals reduce the cost basis. Premiums paid by automatic premium loan are considered out-of-pocket premiums. Dividends used to reduce premiums or purchase paid-up additions do not change the cost basis.

Example: Jose purchased a whole life insurance policy 10 years ago with annual premiums of $10,000.

Basis after paying 10th premium:	$100,000
11th premium paid by automatic premium loan:	$10,000
New basis:	$110,000
12th annual premium paid with $10,000 of dividends:	
New basis:	$110,000 (no change)
Distribution (non-taxable):	$25,000
New basis:	$85,000

7 | Can a policyowner claim an investment loss (on his/her tax return) if the cost basis is higher than the proceeds received from a full surrender or policy lapse?

No, the tax law does not treat life insurance as an investment asset. It is treated as a personal asset and losses resulting from the sale or disposition of personal assets are not deductible.

8 | Is loan interest paid on a life insurance policy tax-deductible?

No, interest paid on loans from individually owned life insurance contracts is generally not deductible. For business-owned policies, see question 26.

9 | What is a 1035 exchange, and what are the tax consequences?

The term "1035 exchange" refers to IRC § 1035. This section permits a taxpayer to exchange certain types of insurance policies or annuity contracts without recognizing a gain on the transaction. When a 1035 exchange occurs, the cost basis of the old policy is transferred to the new policy. **The face amount or coverage amount of the new policy/contract may differ following a 1035 exchange.**

IRC § 1035 permits the following exchanges:

1. A life insurance policy to:
    - Another life insurance policy
    - An annuity contract
    - A qualified long term care insurance policy
2. An annuity contract to:
    - Another annuity contract
    - A qualified long term care insurance policy
3. A qualified long term care insurance policy for another long term care insurance policy.

Neither an annuity contract nor a long term care insurance policy can be exchanged for a life insurance policy under a 1035 exchange. Insurance companies may have restrictions on 1035 exchanges. You should check with the insurance company that issued the current policy and the company that will issue the new policy to determine if they impose any restrictions on 1035 exchanges.

Example: Kate owns a policy with a $50,000 cash value. Kate's basis in this contract is $10,000. Her agent has brought to her attention a new product that will better fit Kate's future needs. If she surrenders the old policy, she will be taxed on $40,000 ($50,000 - $10,000) gain. However, if Kate executes an IRC § 1035 exchange, the $40,000 gain will be deferred and her basis of $10,000 will be carried over to the new policy.

In a 1035 exchange the insured(s) must be the same in the new policy as in the old policy. Further, the policyowner(s) must be the same in the new policy as in the old policy. For example, the ownership of the policy cannot be changed from an individually owned policy to an irrevocable life insurance trust as part of a 1035 exchange. Similarly, a policy insuring two lives cannot be exchanged for a policy insuring a single life. However, following the death of the first insured on a second-to-die policy, the policyowner can exchange the existing policy for a new policy on the life of the surviving insured.

10 | Can a policy with an outstanding loan be exchanged for a new policy under a 1035 exchange?

IRC § 1035 does not prohibit a policy with an outstanding loan from being transferred to a new policy. However, not all insurance companies will allow a loan to be carried over to a new policy. In this case, if a loan is paid off as part of the exchange, the lesser of the gain in the policy or the amount of loan paid off is taxable to the policyowner.

In cases where the new insurance company will allow the loan to be carried over to the new policy, the loan on the old policy is not being paid off, and the policyowner should not have a taxable amount.

Example: Seung owns a policy with an $80,000 basis, $50,000 in policy loans, net cash value of $40,000, and gain of $10,000.

She wants to exchange the policy for a new policy. If the loan is paid off as part of the 1035 exchange, she will report the $10,000 gain as income. Her basis in the new policy is $40,000:

Basis of original policy:	$80,000
Basis applied to loan payoff:	$40,000
Basis in new policy:	$40,000

If the new insurance company allows the loan to be carried over, she will not report any gain as income. Her basis in the new policy is the same as her basis in the original policy, $80,000.

Note, however, it is the surrendering insurance company that is responsible for reporting the transaction to the IRS. It is critical the ceding insurer receives adequate information to ensure that the gain is not reported to the IRS (in cases involving transferred loans).

11 | Can a policyowner take a charitable income tax deduction for donating a life insurance policy to charity?

Yes. The taxpayer must transfer full control of the policy to the charity. This includes both the ownership and choice of beneficiary. If the taxpayer retains any interest in the policy, the charitable deduction will not be allowed. The charitable income tax deduction is limited to the lesser of the policy's cost basis or fair market value on the transfer date. Appraisal requirements may also need to be satisfied. Consult your own tax advisor prior to claiming a charitable income tax deduction for donating a life insurance policy. The tax treatment of a gift of a policy with a loan also applies to a donation of a policy to a charity. Please see question 17 for additional information.

Example: Peter owns a life insurance policy that he no longer needs. The policy has a death benefit of $1,000,000, a cash value of $125,000, and a basis of $100,000. He donates it to a charity. A qualified appraiser determines that the policy's fair market value is $130,000. Peter's deduction is the lesser of:

Policy fair market value:	$130,000
Peter's basis:	$100,000

Peter's charitable income tax deduction for the contribution of the policy is $100,000. The amount he can use may be limited by the adjusted gross income limits on charitable deductions.

12 | If a contributor makes premium payments to a life insurance policy owned by charity, is he or she eligible for a deduction?

Yes, subject to the general rules/restrictions for taking charitable income tax deductions and the following:

- The charity must be a qualifying charitable organization.
- The charity is the owner and beneficiary of the life insurance policy.

Example: Continuing with the previous example, Peter pays the $5,000 premium on the policy directly to the insurance company or makes a $5,000 contribution to the charity so it can pay the policy premium. Peter can deduct the $5,000 payment, subject to the limitations on charitable contributions.

Non-MEC Policy Questions

13 | Are withdrawals/distributions from a life insurance policy subject to income tax?

Policy distributions (i.e., dividends, withdrawals, or partial surrenders) from a life insurance policy are first treated as a return of the cost basis. Only distributions that exceed the policy's cost basis are subject to income tax. Distributions can be used for any reason without affecting the tax consequences — for example, to supplement retirement or education expenses. Cost basis is discussed in further detail in question 6.

Dividends that accumulate at interest are treated as distributions. Interest credited to a dividend accumulation account is currently taxable to the policyowner.

Example: In 2002, Al purchases a whole life policy with a death benefit of $500,000 and premiums of $5,000 per year. After 20 years, Al has paid total premiums of $100,000 (basis) and his policy has a cash value of $300,000. This year, Al wishes to withdraw $10,000 of cash value for education expenses. Since withdrawals from life insurance contracts reduce basis first and since $10,000 is less than Al's $100,000 basis in his policy, this withdrawal will be tax free to Al. However, assuming Al does not pay any more premiums, the next time he wishes to withdraw money from his policy, Al will only have a basis of $90,000. If Al completely withdraws his basis, his next withdrawal will be subject to income tax.

A special rule applies to distributions made during the first 15 policy years if the distribution results in the policy's death benefit being reduced. Under the rule, a portion of the cash distributed — called the "recapture" amount — may be treated as distribution of policy earnings first and subject to tax. Generally, "recapture" results when a policy undergoes a substantial reduction in death benefits, where premium payments were also substantial.

14 | Are policy loans taxable?

The policyowner is responsible for repaying a policy loan, either personally or out of the policy's proceeds. Interest is charged on an outstanding loan.[2] As such, life insurance policy loans are not treated as distributions from the policy, unless the policy lapses while the loan is outstanding.

Note: Policy loans that are eliminated during a 1035 exchange are taxable to the extent of any gain in the policy at the time of the exchange.

Example: In 2012, Michelle purchases a whole life policy with a $300,000 death benefit. Her premiums are $10,000 a year. In 2022, the cash value is $150,000. Michelle needs some money for home improvement projects so she takes a $20,000 loan from her policy. It is the only time Michelle has taken any money out of the policy. The loan to Michelle will be tax free and will accumulate interest while it is outstanding. There is no repayment schedule for the loan. If Michelle dies while the loan is outstanding, assuming no other loans, then the death benefit her beneficiaries receive will be reduced by the outstanding loan, $20,000, and accumulated interest.

[2] Loan interest is charged when a policy loan is taken. If additional policy loans are taken to pay loan interest, the policy's cash/account value will be reduced. At some point, no policy values may be available to pay additional loan interest and out-of-pocket payments will be required to prevent the policy from lapsing. Failure to make an out-of-pocket payment to prevent a policy from lapsing will result in the loss of life insurance coverage and a tax liability in the year of lapse.

15 | What are the consequences if a life insurance policy lapses with an outstanding loan?

When a policy lapses, the total policy debt (loans plus unpaid, accrued interest) is considered a distribution to the policyowner. This will result in taxable income to the extent the policy debt, plus any remaining policy cash value, exceeds the cost basis. If the total debt and remaining cash value do not exceed the cost basis, there are no income tax consequences resulting from the lapse. Policies that lapse with large loan balances can result in a situation where there is a sizable taxable income, but no surrender value to receive.

Example: Same facts as question 14, where Michelle purchases a whole life policy with a $300,000 death benefit. Her premiums are $10,000 a year. The policy lapses in 2027, when Michelle has paid 10 years of premium and has taken loans totaling $125,000. When a policy that has loans outstanding lapses, the loan is treated as a distribution. Michelle will have a taxable event when the policy lapses because she paid a total of $100,000 in premiums (basis) over 10 years and took $125,000 in loans. She will have to include $25,000 ($125,000 - $100,000) plus accrued interest in her income.

16 | If a life insurance policy is surrendered, what are the tax consequences?

The gross surrender proceeds that exceed the cost basis are included in the policyowner's income. "Gross surrender proceeds" include cash received by the policyowner, plus any policy loans and accrued interest, which are paid off at the time of surrender.

Example: Using the same facts from above, in 2012, Michelle purchases a whole life policy with a $300,000 death benefit. Her premiums are $10,000 a year. In 2022, the cash value is $150,000. In 2022, Michelle surrenders her policy. At the time of the surrender, her total premiums were $100,000 and the cash value was $150,000. Michelle will have $50,000 ($150,000 - $100,000) of income since her basis in the policy was $100,000 and she received $150,000 as a result of the surrender.

17 | If a policyowner makes a gift of a policy with an outstanding loan, are there any income tax consequences?

If the loan, including any unpaid interest, exceeds the policy's cost basis, the gift will be treated as a part-gift/part-sale transaction for tax purposes. The result of this transaction is that the policyowner will be treated as having sold the portion of the policy that represented gain, and will be taxed on that amount. This treatment applies to gifts of policies to individuals, trusts, or charities. In addition, the policy is considered to have been transferred for valuable consideration — namely, the donor's release from the policy's debt. Unless an exception to the transfer-for-value rule applies, the beneficiary will be subject to income tax on a portion of the policy's death proceeds. See question 34 for more information on the transfer-for-value rule.

Example: In 2017, Jackie purchases a whole life policy on her life. She paid total premiums of $50,000 and has taken a total of $75,000 in loans. In 2022, she wants to gift the policy to her daughter. This gift will be treated as part-gift/part-sale because the outstanding loan and interest is greater than Jackie's basis in the policy. This means that the amount that is greater than the basis, or gain, of $25,000 ($75,000 - $50,000), will be considered to be sold to her daughter and therefore taxable to Jackie. Jackie's daughter will have a basis in the contract of $75,000. This reflects the original carryover basis of $50,000 plus the $25,000 recognized by Jackie.

Modified Endowment Contract (MEC) Questions

18 | What is a MEC?

A Modified Endowment Contract (MEC) is a special type of life insurance under federal income tax law. Specifically, IRC § 7702A prescribes a test that is intended to distinguish policies that are purchased primarily for investment from policies that are purchased primarily for death benefit protection.

19 | How is MEC status determined?

A premium limit is set to determine if a contract is a MEC. This limit (referred to as a 7-pay limit or MEC limit) is based on the annual premium that would pay the policy in full in seven level annual payments. To avoid MEC status, this limit sets the maximum premium able to be paid into the policy from the date of issue until the policy's seventh anniversary. Under what is known as the MEC test, the cumulative amount paid at any time during the first seven years cannot exceed the cumulative MEC limit for that policy year.

These rules aim to eliminate some of the favorable life insurance tax treatments for rapidly funded life insurance policies, and apply to life insurance policies issued on or after June 21, 1988. A policy issued prior to that date can become subject to these rules, primarily if the death benefit is increased or riders are added after that date.

20 | How is the death benefit of a MEC taxed?

A MEC is still life insurance, and its death benefit proceeds are generally exempt from income tax as explained in question 1.

21 | Do MEC policy values grow tax-deferred like non-MEC policies?

Yes, MECs must still meet the definition of life insurance so cash value accumulations on a MEC is generally not subject to current tax if not withdrawn. However, if a MEC is pledged as collateral for a loan or a policy loan is taken, then any gains up to the amount of loan or pledge will be recognized.

22 | How are distributions from a MEC taxed?

Generally, distributions from a MEC are taxed as earnings first, followed by a return of the policy's cost basis. Therefore, distributions are taxable to the extent of gain. For this purpose, loans, pledges, and collateral assignments of a MEC are treated as distributions. Any portion of the distribution that is taxed increases the policyowner's basis in the policy.

- **Dividends** – Dividends are taxed as a distribution of income first for a MEC policy unless they are retained by the insurer as premiums or other considerations for the policy. Dividends held to accumulate at interest, or retained to repay loan principal or interest, are considered MEC distributions.
- **Full Surrenders** – The amount received (which includes outstanding debt) is included in the policyowner's gross income to the extent it exceeds the policy's cost basis.
- **Partial Surrenders/Withdrawals** – Distributions are treated as policy earnings first. Distributions over the amount of policy gain are a return of the policy's cost basis. For partial surrenders or withdrawals, the gain is determined by the gross cash value (without regard to debt or surrender charges) minus the cost basis.
- **Loans and Collateral Assignments** – A policy loan is taxed in the same manner as a distribution. A collateral assignment is treated as a loan. Loans or collateral assignments are treated as a distribution and included in income, which increases the policy's cost basis.
- **Premature Distributions** – An additional 10% penalty tax applies to income distributed from a MEC prior to the policyowner's age 59½. Certain exceptions are provided for distributions following the disability of the policyowner, or for distributions of an IRS-approved series of substantially equal periodic payments.

23 | Do changes to the insurance policy cause the policy to be retested?

Material changes will cause the policy to be retested as if it was issued on the date of the change. This means starting a new 7-pay period and setting a new 7-pay premium. Material changes include certain increases in the death benefit or the addition of riders. A reduction in benefits during a 7-pay period requires the policy be retested as if it was issued at the reduced level of benefits from the start of the 7-pay. For survivorship policies, reducing the death benefits at any time requires retesting.

Business-Related Questions

24 | Are life insurance premiums deductible for a business owner?

No. Life insurance premiums are not deductible if the business is a beneficiary of the policy (directly or indirectly).

25 | What are the special requirements that have to be met for employer-owned life insurance?

The Pension Protection Act of 2006 enacted IRC § 101(j). It states the death benefit of an employer-owned life insurance policy will not be income tax-free under IRC § 101(a) unless:

- The employer fulfills a specific Notice and Consent Requirement before the policy is issued. The Notice to the insured must provide that:
  - The employer intends to purchase the insurance on the life of the employee, and the maximum amount to be applied for;
  - The employer will be a beneficiary of the policy (including in the case of a split dollar arrangement); and
  - The insured employee must consent to the purchase, specifically to the fact that the insurance may continue after the employment relationship terminates.
- If the Notice and Consent Requirements are met, the death proceeds will be tax-free if:
  - The deceased employee was a recent employee. He or she must have died within 12 months of being an employee; or
  - The proceeds are used by the employer to pay family members of the insured (or a trust for their benefit) or to purchase or redeem a financial interest the insured owned in the business; or
  - At the time the insurance was issued, the insured:
    - Was a director of the employer;
    - Was at least a 5% owner at any time during the preceding year;
    - Received compensation over $135,000 (for 2022) during the preceding year;
    - Was one of the five highest paid officers; or
    - Was among the highest paid 35% of all employees.

26 | Can a business take an income tax deduction for interest paid on a life insurance policy loan?[2]

Perhaps, but with significant restrictions. Loan interest is deductible on aggregate life insurance loans of $50,000 per individual. However, if loans were incurred to purchase or carry the life insurance policy, the business must have paid at least four of the first seven annual premiums without using debt (as the premium source).

The deduction for business-owned life insurance is limited to policies covering the life of a key person, defined as an officer or 20% owner of the business.

The deductible loan interest is subject to a maximum interest rate equal to the Moody's Corporate Bond Yield Average.

Even if the business does not take a policy loan, there is an additional disallowance rule for loan interest paid by a business that owns a cash value life insurance policy other than policies on the lives of at least 20% owners of the business, officers, directors and employees. Businesses should consult with their own tax and legal counsel prior to deducting loan interest.

27 | What are the tax consequences if an employer pays the premiums on a policy owned by an employee?

Unless it is structured as a split dollar arrangement, the employee is taxed on the entire employer premium payment. Under an economic benefit split dollar arrangement, the employee is taxed on the term insurance value of the life insurance policy's death benefit in excess of the employer's share of the policy death benefit, usually equal to the policy's cash value.

Alternatively, the arrangement may be a split dollar loan. Under this arrangement, the employer loans the premiums to the employee. The tax code requires that the employee either pay or be taxed annually on a market rate of interest on the outstanding split dollar loan amount.

28 | What are the employee's income tax consequences if an employer transfers the policy ownership to the employee?

The fair market value of the life insurance policy is taxable as compensation to the employee. Fair market value is determined under the guidance issued by the IRS (Rev. Proc. 2005-25) as the greater of the policy's:

1. Interpolated terminal reserve, or
2. PERC (i.e., premiums paid plus earnings minus reasonable charges).

No surrender charges are taken into consideration.

29 | What are the tax consequences to a business when it distributes a policy to an employee?

If the policy is distributed to the employee without consideration, the fair market value of the policy is treated as compensation, and the employer may be eligible for a deduction under the rules generally applicable to compensation. In addition, if there is any gain in the policy the distribution is treated similarly to a sale of the policy, and the employer will be taxed on that gain. If the employer is a pass-through entity, such as an LLC, S Corporation or a partnership, any gain or deduction will flow through to the members/shareholders/partners according to the general rules governing such allocation.

30 | What are the tax consequences to a business owner when a policy is transferred to them in their capacity as such?

Where a policy is transferred to someone as an employee, see questions 28 and 29.

While the transfer will generally be treated as a distribution, the surrounding circumstances, including the nature of the business (corporation, partnership, etc.) will determine the specific tax treatment. The transfer could be taxed as a dividend, but could also be considered capital gain or return of capital. Again, the specific circumstances will drive this determination, and you should consult a tax professional for guidance.

31 | What are the tax consequences to a business when a policy is transferred to its owner(s)?

The business must recognize any gain in the policy when it is transferred (see question 29). Depending on the nature of the business, this gain may be recognized by the entity (in the case of a corporation) or be passed through to the owners (in the case of pass-through entities).

32 | How is the death benefit of an employer-owned policy taxed if the employee's spouse is the beneficiary?

As the policyowner, the death benefits are deemed to be paid to the employer and received income tax-free. The employer is then treated as having transferred the death benefit to the employee's spouse as a taxable benefit. There should be a written agreement to provide such benefit to ensure the employer receives an offsetting income tax deduction for the payment to the employee's spouse.

33 | What are the tax consequences if the owner exercises the Transfer of Insureds Rider?

The Transfer of Insureds Rider allows the business owning the life insurance policy to change the person insured under the policy. This rider is typically used following the end of the insured's employment with the business. Any gain in the policy is taxable to the owner at the time of the transfer, as the "exchange" does not qualify as a tax-free exchange under IRC § 1035.

34 | What is the transfer-for-value rule?*

The IRC provides that if a life insurance policy, or any interest within, is transferred for valuable consideration, the death benefit in excess of the premiums or other consideration paid by a transferee is subject to federal income taxation (IRC § 101(a)(2)).

Transfer-for-value situations commonly arise in cross-purchase buy-sell arrangements involving corporate shareholders. Consider the following examples:

1. Assume there are three shareholders: Al, Jackie, and Pat. Each owns life insurance on the other two shareholders. If Pat dies first, then Al and Jackie collect the death proceeds from the policies they owned insuring Pat. They use the proceeds to purchase Pat's interest in the corporation from his estate. As part of the transaction with Pat's estate, Al and Jackie receive the life insurance policies on each other that Pat had owned. Transferring Jackie's policy from Pat's estate to Al, and Al's policy to Jackie, are transfers for valuable consideration, thus subjecting the policies' death proceeds to federal income tax.
2. Todd and Erin each own a life insurance policy on their own life. They form a corporation and become the only two shareholders. Rather than purchasing new life insurance policies, Todd names Erin as the beneficiary of his policy and Erin names Todd as the beneficiary of her policy. When one of them dies, the life insurance policy proceeds payable to the other constitute a transfer-for-value. Even though ownership of the policies did not change, Todd named Erin as the beneficiary of his policy because Erin named Todd as the beneficiary of her policy. Their actions represent mutual promises, i.e., a bargain for exchange.
3. Suppose AK Corporation owns life insurance on the lives of Kate and Adam. If the corporation transfers ownership of Kate's policy to Adam and Adam's policy to Kate, these are transfers-for-value. Note, it doesn't matter whether the policies have cash value or not; the value actually transferred has no bearing over whether a transfer-for-value has occurred.

35 | Are there exceptions to the transfer-for-value rule?*

The following transfers are not treated as transfers-for-value:

- Transfers to the insured or a grantor trust of which the insured is the grantor for tax purposes.
- Transfers to a partner of the insured.
- Transfers to a partnership in which the insured is a partner.
- Transfers to a corporation in which the insured is an officer or stockholder.
- Transfers where the transferee's cost basis in the policy is determined by reference to its basis in the hands of the transferor (e.g., gifts and transfers between spouses).

* **Note:** IRC § 101 was amended by The Tax Cut and Job Creations Act of 2017 and final regulations published October 31, 2019 to add a new category to the transfer-for-value rules entitled Reportable Policy Sale. If a prior or current transfer has been deemed a Reportable Policy Sale, the policy will be tainted and exceptions to the transfer-for-value rules will not apply. Although most traditional acquisitions or transfers of a life insurance policy (i.e. estate planning, buy-sell funding, life insurance funded executive benefits) should not trigger a Reportable Policy Sale, you should consult with your personal tax or legal advisors prior to transferring a life insurance policy.

36 | How can a cross-purchase buy-sell arrangement be structured without causing a transfer-for-value?

Each shareholder must be the original applicant and owner of the life insurance policy on the other shareholder's life so that there is no "transfer" that could trigger the transfer-for-value rule. Alternatively, the co-shareholders can form a partnership with a business purpose. Once the co-shareholders become each other's partners, ownership of a life insurance policy could be transferred (to a partner of the insured) without creating a transfer-for-value.

37 | If the transfer-for-value rule has been violated, can the problem be rectified?

Yes, a subsequent transfer to an individual or entity coming within one of the exceptions (if the policy does not have a Reportable Policy Sale taint) noted in question 35 can be used to clear the prior transfer-for-value. For example, the owners of a corporation decide to switch their buy-sell arrangement from stock redemption to cross-purchase. The life insurance policy on the life of shareholder A is distributed to shareholder B, and vice versa. Upon realizing that they have created a transfer-for-value, shareholders A and B both transfer ownership of the two policies back to the corporation.

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