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TRANSFERRING LIFE INSURANCE POLICIES FOR CONSIDERATION
— by Neil E. Harl*

In general, amounts received by a beneficiary as death benefit proceeds under a life insurance contract are excludable from the beneficiary's income. This is the applicable rule where payment is made to the estate of the insured or to a designated beneficiary and whether paid directly or in trust. Recently, regulations have been proposed that would allow the payment of benefits prior to death without income tax liability to the recipient if death is expected to occur within 12 months.

A greater concern is the income tax treatment of policy proceeds where the life insurance is transferred not as a gift but for value.

Transfer for value rule

If a life insurance policy is transferred for valuable consideration, for value, the amount excludable from income is limited to the consideration paid plus premiums and other amounts paid subsequently by the transferee. Thus, a substantial part of the policy proceeds could be subject to income tax. There are, however, two exceptions to this "transfer for value" rule:

- If the transfer for value is to the insured, to a partner of the insured, to a partnership in which the insured is a partner or to a corporation in which the insured is a shareholder or officer, the policy proceeds are not taxable as income to the beneficiary. This is the "exempt persons" exception to the transfer for value rule.

- If the income tax basis of the policy is determined in whole or in part by reference to the basis of the contract in the hands of the transferor, the proceeds are not taxable as income to the beneficiary. This is the "carryover basis" exception to the transfer for value rule.

In general, once a policy is transferred for value, the income exclusion available if there is a subsequent transfer by gift is limited to the amount that could have been excluded by the transferor plus any premiums paid by the recipient of the policy.

Loan on policy

Transfers of life insurance policies by sale or exchange are relatively rare so the transfer for value rule is only infrequently invoked for such transfers. What is more common is the transfer of a policy encumbered by a policy loan. In some instances, transfers of that type could trigger the transfer for value rule. If the policy loan exceeds the transferor's basis in the policy, the transferor could be taxed (for income tax purposes) on the difference between the basis and the outstanding loan at the time of the transfer.

An assumption by the transferee of the outstanding loan on a policy may constitute valuable consideration given by the transferee. Litigated cases have established that valuable consideration is not limited to money or other property. The result could be that the proceeds in excess of the transferee's basis in the policy would be included in the beneficiary's income.

However, as noted above, if a transferee's basis is determined in whole or in part by reference to the transferor's basis, the transfer may come within the carryover basis exception to the transfer for value rule. Thus, except where the transferor borrows on the cash value an amount in excess of the income tax basis in the policy, a transfer of a life insurance policy which is part gift-part "sale" should not subject the proceeds to income taxation. The transfer should come within the carryover basis exception to the transfer for value rule. In the event the loan exceeds the cash value of the policy, a transfer of the policy would seem not to come within the carryover basis exception to the transfer for value rule and the proceeds could be taxable to the policy beneficiary.

Certainly, care should be exercised in transfers of life insurance policies where there is a loan on the policy.

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FOOTNOTES
1 I.R.C. § 101(a)(1).
3 I.R.C. § 101(a)(2).
6 Treas. Reg. § 1.101-1(b)(2).
9 See I.R.C. § 101(a)(2).
10 See note 5 supra.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

DISMISSAL. The debtor had originally filed a Chapter 12 bankruptcy case and a creditor had filed a motion for relief from the automatic stay in that case. The debtor discovered that the debtor was not eligible for Chapter 12 and voluntarily dismissed the Chapter 12 case and refiled for Chapter 11. The creditor argued that Section 109(g) prohibited the second filing within 180 days after a voluntary dismissal of a case in which a motion for relief from the automatic stay had been filed. The court held that Section 109(g) was not mandatory and that a second filing would be allowed because the debtor did not dismiss the first case and refile only to prevent the creditor from obtaining relief from the automatic stay. Tooke v. Sunshine Trust Mortgage Trust No. 86-225, 149 B.R. 687 (M.D. Fla. 1992).

EXEMPTIONS

AVOIDABLE LIENS. The debtors claimed an exemption under 11 U.S.C. § 522(d)(5) for $4,235 of the equity in their homestead. The debtors sought avoidance of a $300,000 second lien against the homestead as impairing their exemption. The court held that the lien could be avoided only to the extent of the debtors’ claimed exemption amount. The remaining portion of the lien was held to be subordinate to the exemption amount after conclusion of the bankruptcy case. In re Gonzalez, 149 B.R. 9 (Bankr. D. Mass. 1993).

Twelve days before filing for bankruptcy the debtor transferred homestead property to the debtor and the debtor’s spouse as joint tenants. The debtor and spouse filed a joint bankruptcy case and each claimed the Maine $60,000 homestead exemption. The homestead was subject to a mortgage in excess of the fair market value and to two judgment liens. No objections to the exemption claims were filed and the debtors sought to avoid the judgment liens as impairing the homestead exemptions. The court held that because the judgment liens attached to the homestead before the transfer to the spouse, the spouse could not avoid the judgment liens. The court also held that the debtor could not avoid the judgment liens because the debtor had no equity in the homestead, even if the judgment liens were avoided. In re Saturley, 149 B.R. 245 (Bankr. D. Me. 1993).

HOMESTEAD. When a creditor attempted to levy on real property owned by the debtor, the debtor claimed the property eligible for a homestead exemption. The state court denied the debtor’s claim and the creditor sought a sale of the property. The sale was prevented by the debtor’s bankruptcy filing, in which the debtor again claimed the property as an exempt homestead. The creditor failed to timely object to the exemption but objected when the debtor sought an avoidance of the lien as impairing the exemption. The court held that the failure to timely object to the exemption prohibited any denial of the exemption; however, the court also ruled that the failure to object to the exemption did not prevent the denial of the exemption for purposes of lien avoidance. The court also held that the Bankruptcy Court’s denial of the avoidance because of giving full faith and credit to the state court denial of the exemption was improper because the debtor’s eligibility for the exemption had to be determined as of the date of the petition and the facts and circumstances could have changed between the state court ruling and the filing of the petition. In re Morgan, 149 B.R. 147 (Bankr. 9th Cir. 1993).

Under a divorce settlement, the debtor had received money for the debtor’s interest in the marital homestead in Michigan. The debtor moved to Kansas and filed for bankruptcy, claiming the money as exempt proceeds from the sale of a homestead. The court held that because the debtor would not have been allowed a Kansas exemption for a Michigan homestead, the debtor could not claim a homestead exemption from the proceeds of a Michigan homestead. In re Sipka, 149 B.R. 181 (D. Kan. 1992).

The debtor had executed a deed of trust encumbering the debtor’s rural homestead and had signed a waiver asserting that the property was not the debtor’s homestead although the property was the debtor’s residence at that time and when the bankruptcy petition was filed. The secured creditor objected to the debtor’s homestead