NOTE

APPLICATION OF THE TRANSFER FOR VALUE RULE UNDER INTERNAL REVENUE CODE SECTION 101(a)

INTRODUCTION

In determining an individual's taxable income, one might well assume that all monies received by the individual in a particular year would be included in his gross income.[1] However, this is not so. Congress has expressly excluded several sources of income from the gross income figure.[2] One notable exclusion, I.R.C. section 101(a), deals with proceeds from life insurance contracts payable by reason of the death of the insured. However, Congress has also provided an exception to the general exclusion rule of this section of the Internal Revenue Code. Where a life insurance contract is transferred for valuable consideration, the exclusion is limited to the actual value of the consideration plus any premiums paid subsequent to the transfer. This exception is commonly referred to as the "transfer for value rule."[3] In addition, there are two special instances where this transfer for value rule will not be applicable. These two situations are considered exceptions to the exception.

This Note explores the various aspects and applications of I.R.C. section

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1. This is especially so when one considers the broad definition of gross income in I.R.C. § 61(a):

> (a) General Definition. -Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
> (1) Compensation for services, including fees, commissions, and similar items;
> (2) Gross income derived from business;
> (3) Gains derived from dealings in property;
> (4) Interest;
> (5) Rents;
> (6) Royalties;
> (7) Dividends;
> (8) Alimony and separate maintenance payments;
> (9) Annuities;
> (10) Income from life insurance and endowment contracts;
> (11) Pensions;
> (12) Income from discharge of indebtedness;
> (13) Distributive share of partnership gross income;
> (14) Income in respect of a decedent; and
> (15) Income from an interest in an estate or trust.

2. Actually, several of the exclusions are not "income" in the true sense of the word, but rather are returns on capital investment. The exclusion of proceeds from life insurance policies or annuities are examples of a return on capital investment. Congress has historically excluded these items from federal income tax computation. *See generally* J. CHOMMIE, FEDERAL INCOME TAX § 15 (1973).

3. *See* 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.07 (Supp. 1978).

101(a),[4] concentrating on the transfer for value rule and its exceptions. Part I briefly examines I.R.C. section 101(a)(1), the general rule excluding life insurance contract proceeds from gross income. Part II analyzes I.R.C. section 101(a)(2), the transfer for value rule. In Part III, I.R.C. section

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4. I.R.C. § 101(a) provides as follows:

> Certain death benefits
>
> (a) Proceeds of life insurance contracts payable by reason of death.-
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> (1) General rule.-Except as otherwise provided in paragraph (2) and in subsection (d), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.
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> (2) Transfer for valuable consideration.-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 by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee. The preceding sentence shall not apply in the case of such a transfer-
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> > (A) if 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
> >
> > (B) if such transfer 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.

It should be pointed out that many of the cases discussed in this Note were litigated prior to the Internal Revenue Code of 1954. For the purposes of this Note, however, it will be assumed that the language and intent of the sections are similar. In fact, the language of the exclusion rule and the transfer for value rule have changed very little since their inception in Section II(B) of the Income Tax Act of 1913. *See* Revenue Act of 1916, ch. 463, § 4, 39 Stat. 756, 758; Revenue Act of 1917, ch. 63, § 1200, 40 Stat. 300, 329; Revenue Act of 1918, ch. 18, § 213(b)(1), 40 Stat. 1057, 1065; Revenue Act of 1921, ch. 136, § 213(b)(1), 42 Stat. 227, 238; Revenue Act of 1924, ch. 234, § 213(b)(1), 43 Stat. 253, 267; Revenue Act of 1926, ch. 27, § 213(b)(1), 44 Stat. 9, 24; Revenue Act of 1928, ch. 852, § 22(b)(1), 45 Stat. 791, 797; Revenue Act of 1932, ch. 209, § 22(b)(1), 47 Stat. 169, 178; Revenue Act of 1934, ch. 277, § 22(b)(1), 48 Stat. 680, 687; Revenue Act of 1936, ch. 690, § 22(b)(1), 49 Stat. 1648, 1657; Revenue Act of 1938, ch. 289, § 22(b)(1), 52 Stat. 447, 458; Int. Rev. Code of 1939, ch. 2, § 22(b)(1), 53 Stat. 1, 10.

For an example of the similarities, compare I.R.C. § 101(a), *id.*, with section 22(b)(1) of the 1936 Code, which reads as follows:

> . . .
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> (b) Exclusions from Gross Income - The following items shall not be included in gross income and shall be exempt from taxation under this title:
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> (1) Life Insurance - Amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise (but if such amounts are held by the insurer under an agreement to pay interest thereon, the interest payments shall be included in gross income);
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> (2) Annuities, Etc. - . . . In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest thereon, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) of this paragraph.

Int. Rev. Code of 1936, ch. 690, § 22(b)(1), 49 Stat. 1648, 1657.

101(a)(2)(A) and (B), the exceptions to the transfer for value rule are considered.

I. Section 101(a)—The General Exclusion Rule

The general rule established in section 101(a) provides that proceeds from life insurance contracts payable by reason of death of the insured are exempt from tax.[5] The legislative intent behind section 101(a) is to shield from tax the proceeds from life insurance policies intended to assist the deceased's survivors, whether individuals or business interests.[6] However, the proceeds from a life insurance policy entered into for purely speculative reasons will not be protected.[7]

The major problem arising in this context is the determination of what is encompassed by the term "life insurance contract."[8] Although Congress has never defined this term for the purposes of this section,[9] it is well established that courts will not be bound by the form of the life insurance policy, but rather, will look to the substance of the arrangement.[10]

Historically, courts have required policies to possess three elements in order to be considered a life insurance contract within the meaning of section 101(a).[11] To qualify as a contract, a policy must involve a true insurance risk, deal with an insurable interest and possess certain characteristics inherent in a life insurance arrangement.

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5. *See generally* J. Chommie, Federal Income Tax § 37 (1973); 1 Couch on Ins. 2d §§ 2:1-2:9 (Supp. 1977); 1 J. Mertens, Law of Federal Income Taxation §§ 701-708 (Supp. 1978).

6. S. Rep. No. 1622, 83d Cong., 2d Sess. 14 (1954).

7. *Id.*

8. For purposes of this Note, the term "life insurance contract" refers to an insurance arrangement which satisfies the legislative intent behind the general exclusion rule for proceeds under section 101(a). This is in contrast to "Life insurance policy," a broad term, referring to any arrangement which purports to provide insurance benefits to the survivors of the policy. "Life insurance contract," on the other hand, is a narrower concept: not only is it a life insurance policy, but it also satisfies the intent of I.R.C. § 101(a). A discussion of what is required to satisfy the legislative intent of I.R.C. 101(a) follows in the text.

9. *See* 50 Cong. Rec. 508, 1257-59; H.R. Rep. No. 767, 65th Cong., 2d Sess. 9 (1939-1 Cum. Bull. (Pt. 2) 86, 92); S. Rep. No. 617, 65th Cong. 3d Sess. 6 (1939-1 Cum. Bull. (Pt. 2) 117, 121); S. Rep. No. 52, 69th Cong., 1st Sess. 20 (1939-1 Cum. Bull. (Pt. 2) 332, 347); H.R. Rep. No. 356, 69th Cong., 1st Sess. 33 (1939-1 Cum. Bull. (Pt. 2), 361, 363-64); H.R. Rep. No. 704, 73d Cong., 2d Sess. 21 (1939-1 Cum. Bull. (Pt.2) 554, 569); S. Rep. No. 558, 73d Cong., 2d Sess. 23 (1939-1 Cum. Bull. (Pt.2) 586, 603); S. Rep. No. 781, 82d Cong., 1st Sess. 50 (1951-2 Cum. Bull. 458, 493); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A29-A32, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4017, 4166-68; S. Rep. No. 1622, 83d Cong., 2d Sess. 14-15, 179-82, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4621, 4643-45, 4814-16; H.R. Rep. No. 2543, 83d Cong., 2d Sess. 23-24, *reprinted in* [1954] U.S. Code Cong. & Ad. News 5280, 5283.

10. "The principle of looking through form to substance is no school boy's rule; it is the cornerstone of sound taxation . . . [for] 'tax law deals in economic realities, not legal abstractions . . . .' " Weinart's Estate v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961)(citing Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956)). *See also* Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935).

11. *See* 1 J. Mertens, Law of Federal Income Taxation § 7.06 (1969).

A. Insurance Risk

To qualify under section 101(a), the life insurance policy must involve an insurance risk, as opposed to merely an investment risk. In *Helvering v. Le Gierse*,[12] it was established that an insurance risk involves the binding arrangement of "risk-shifting" and "risk-distribution." "Risk-shifting" emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and the insured, each of whom gamble on the time the latter will die. In contrast, "risk-distribution" emphasizes the broader, social aspect of insurance as a method of dispelling the danger of the potential loss by spreading its cost throughout a group.[13] In *Le Gierse*, the Supreme Court stated that even though a policy may have the form of a life insurance contract, the proceeds will not be excluded from gross income under section 101(a) unless the policy included both these essential elements.

This approach was utilized by the Fifth Circuit in *Ross v. Odom*,[14] where an insurance risk was found to exist in a program established to provide benefits to survivors of state employees, even though there were no express life insurance contracts.[15] The program involved approximately 20,000 participants who, in accordance with accepted actuarial computations, contributed to a common fund from which benefits were provided to the survivors of the participating state employee.[16] The court found a sufficient insurance risk in that an individual employee effectively shifted the risk of his untimely death from his survivors to the common fund. Furthermore, the risk of loss which was shifted to the common fund was, in turn, distributed among the large number of participants.[17] Thus, the dual requirements of risk shifting and risk distribution were met, and the court therefore held that the proceeds from the policy were excludible under section 101(a).[18]

However, a contrary result was reached in *Kess v. United States*,[19] in which no insurance risk was found where a life insurance policy was issued

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12. 312 U.S. 531 (1941).

13. Commissioner v. Treganowan, 183 F.2d 288, 291 (2d Cir. 1950). *See also* Note, *The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance*, 59 YALE L.J. 780, 784 (1950).

14. 401 F.2d 464 (5th Cir. 1968).

15. All courts appear to agree that, in order to come within the purview of I.R.C. § 101(a), the insurance agreement need not be in the form of the standard life insurance contract. Mary Tighe, 33 T.C. 557, 564 (1959). *See* note 8 *supra*. *See also* Estate of Moyer, 32 T.C. 515 (1959).

16. The court emphasized that, in order to fully distribute the risk, the amounts of the contributions must be actuarially adequate to pay the benefits of all participants. 401 F.2d at 468. This, however, is not an absolute necessity for an insurance program. *See* Haynes v. United States, 353 U.S. 81, 84 (1957).

17. In this regard, the program was similar to the New York Stock Exchange Gratuity Fund, which was also held to constitute insurance. *See* note 13 *supra*.

18. The dissent argued that the program should not have been considered life insurance under I.R.C. § 101(a), but rather was more of an employees' death benefit, which would fall under section 101(b). 401 F.2d at 474 (Fahy, J., dissenting).

19. 72-1 U.S.T.C. (CCH) ¶ 9,102 (1972).

simultaneously with a pure annuity contract. The court, looking to the substance of the arrangement, concluded that the insurance policy and the annuity were opposites in that the latter neutralized the risk customarily inherent in the former. By combining the policy with the annuity, the company minimized the risk of an insured's early death, and, therefore, in essence had only an investment risk.[20]

From the above discussion, it is apparent that before a policy will be considered to be a true life insurance contract for purposes of section 101(a), it must be shown to involve an insurance risk in addition to an investment risk. This means that the arrangement is such that the risk of an untimely death is shifted to and distributed among a larger number of individuals who can absorb the impact of an occasional death without undue adverse financial consequences. Unless this element is found to be present, the policy will not be considered to be an insurance contract, and the section 101(a) exclusion will not be available.

B. *Insurable Interest*

In addition to an insurance risk, courts also require the presence of an insurable interest before a particular policy will qualify for the section 101(a) exclusion. An insurable interest has been defined as "any reasonable expectation of pecuniary benefit or advantage from the continued life of another . . . ."[21] It has also been described as "an interest in having the life continue; a person has an insurable interest in the life of another where there is a reasonable probability that he will gain by the latter's remaining alive or lose by his death."[22] Some common examples of insurable interest include the interest of one spouse in the life of another, of a corporation in its president and of a partnership in its partners.

In those situations in which a life insurance policy is taken out by one with no insurable interest in the life of the insured, there exists a wagering agreement rather than a life insurance contract within the generally accepted meaning of the phrase.[23] The legislative intent behind the insurable interest requirement is to exclude from gross income the proceeds from bona fide life insurance contracts but to include in that figure proceeds from pure wagering agreements.[24]

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20. The court was particularly impressed with the fact that no evidence of insurability was required for the life insurance policy if and only if the insurance policy was issued simultaneously with an annuity. *Id.* The court noted that the result of the case may have been different if the two policies were severable, since in such a situation the annuity would not be present to neutralize the risk of the life insurance contract. *Id. See* Fidelity - Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958); Rev. Rul. 65-57, 1965-1 C. B. 56.

21. Connecticut Mut. Life Ins. Co. v. Schaefer, 94 U.S. 457, 460 (1876).

22. Polan v. Fisher's Estate, 329 S.W.2d 768, 772 (Mo. 1959)(citing 44 C.J.S. *Insurance* § 203 (1945)).

23. Atlantic Oil Co. v. Patterson, 331 F.2d 516 (5th Cir. 1964). *See generally* 1 J. Mertens, Law of Federal Income Taxation § 703 (1969).

24. S. Rep. No. 1622, 83d Cong., 2d Sess. 14 (1954).

The insurable interest requirement may be deemed satisfied in circumstances other than the more common situations listed above. For example, in *M. Lucile Harrison*,[25] a real estate organization invested a great deal of money in a major development. The organization was confident that it could make this investment profitable, mainly because of the business expertise and acumen of Chester Mason, a co-developer. In order to protect this prospective gain, the organization took out a $500,000 life insurance policy on Mason, naming itself beneficiary. The court held that the organization had an insurable interest in Mason because of their "mutual business interests."[26]

Another example of the insurable interest requirement is found in *Ducros v. Commissioner*,[27] where a corporate president took out a life insurance policy on himself, naming the corporation as beneficiary, but reserving to himself the right to change beneficiaries. The beneficiaries were later changed to three of the corporation's major stockholders. The court held that since both the corporation and the shareholders stood to lose from an early demise of the president,[28] an insurable interest did exist.[29]

Not all "employer-employee" relationships, however, will be sufficient to give rise to an insurable interest on the part of an employer or employee. For example, in *Atlantic Oil Co. v. Patterson*,[30] the taxpayer-employer required all its prospective employees to apply for life insurance on their own lives as a condition of employment. The employer selected the insurance companies and paid the premiums. The court upheld a jury determination that there was no insurable interest involved, and that the insurance policy was therefore void as a wagering agreement for purposes of the section 101(a) exclusion.[31]

As the above discussion indicates, the requirement of an insurable interest will generally be met in situations where the beneficiary of the policy will stand to lose, from a pecuniary standpoint or otherwise, by the early demise of the insured. As a general matter, the presence or absence of this element will be determined by the facts of the particular case. Additionally, as

25. 59 T.C. 578 (1973).

26. This is an example of a "key man" life insurance policy - although Mason was never a partner, employee, shareholder, officer or director of the real estate organization, he was still an integral part of their business plans. *Id.* at 582.

27. 272 F.2d 49 (6th Cir. 1959).

28. The court also cited the fact that an insurable interest existed at the time of inception of the life insurance policy, the corporation's interest in its president. The court stated that this was sufficient to make the life insurance policy valid. *Id.* at 51.

29. The Internal Revenue Service has ruled that it will not follow the decision in *Ducros*. Rev. Rul. 61-134, 1961-2 C.B. 250. The Commissioner expressed the opinion that life insurance proceeds paid to the shareholders of a close corporation are taxable as dividends in cases where the corporation uses its earnings to pay the premiums and has all the incidents of ownership, as was the case in *Ducros*. *Id.*

30. 331 F.2d 516 (5th Cir. 1964).

31. The jury was charged that if they found the employees were economically coerced into taking out the policies, the policies would be void as wagering agreements. *Id.* at 517.

pointed out in *Atlantic Oil Co. v. Patterson*,[32] this interest must be specific and significant, otherwise, the policy may be declared a wagering agreement, and therefore the exclusion provided by section 101(a) will not be available.

C. *Life Insurance Contract Characteristics*

The third requirement for qualification under the section 101(a) exclusion is that the policy possess certain characteristics inherent in a life insurance arrangement. In this regard, courts tend to view a life insurance contract in the strict sense of the term. The basic characteristics considered include payment of proceeds only by reason of the death of the insured, inclusion of the principal amount of the policy in proceeds and an arrangement whereby the life insurance contract constitutes more than employee death benefit.

In requiring that the proceeds be paid only by reason of the death of the insured, courts have respected the congressional purpose underlying section 101(a): the exclusion of only those amounts intended by the insured to provide funds for his survivors.[33] An example of this reasoning is found in *Tennessee Foundry & Machine Co. v. Commissioner*,[34] in which an employee of the petitioner left a suicide note confessing to the embezzlement of company funds. The widow of the deceased employee, on her own behalf and as administratrix of the deceased's estate, entered into a settlement agreement with the petitioner. As part of this agreement, the widow executed an assignment to the petitioner of all rights in and monies payable under a life insurance policy in which the widow was the named beneficiary. The court would not allow the proceeds to be excluded from the petitioner's gross income because the proceeds were not received by reason of the death of the insured,[35] but rather were received by way of the settlement agreement with the widow.[36]

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32. 331 F.2d 516 (5th Cir. 1964).

33. S. Rep. No. 1622, 83d Cong., 2d Sess. 14 (1954).

34. 48 T.C. 419 (1967), *aff'd*, 399 F.2d 156 (6th Cir. 1968).

35. As *Tennessee Foundry* indicates, the requirement that the proceeds be payable by reason of the death of the insured is strictly construed. *Compare* Landfield Fin. Co. v. United States, 296 F. Supp. 1118 (N.D. Ill. 1968) (the court ruled that where plaintiff, in the business of making loans, required the borrower to name plaintiff beneficiary on a life insurance contract, any proceeds from these policies were not excludible under section 101(a)) *and* Rev. Rul. 70-254, 1970-1 C.B. 31 (the Commissioner ruled that where the sellers of land routinely took out term life insurance on the life of the purchaser, proceeds from these policies are business proceeds, not excludible under section 101(a)) *with* Thomsen & Sons, Inc. v. United States, 484 F.2d 954 (7th Cir. 1973)(the court held it was not error for a judge to instruct the jury to "use your own good common sense" as to whether proceeds were received by reason of death of the insured).

The equitable right to "proceeds" of an insurance policy is not equivalent to the beneficiary's right to receive the amount of the proceeds "by reason of the death of the insured." Tennessee Foundry & Machinery Co., 48 T.C. 419, 428 (1967).

36. The requirement that the life insurance contract proceeds be payable at the death of the insured must be distinguished from life insurance policies in which the proceeds are payable in the form of an annuity. Policies in the nature of the latter do not qualify under the section 101(a) exclusion, and are dealt with in I.R.C. § 72.

Courts also require that the proceeds include the principal amount, or the face value, of the policy.[37] For example, in *Rubye K. Strauss*,[38] the petitioner was the beneficiary of the deceased's life insurance policy. Under an option of the policy, he elected to allow the insurer to hold the principal of the policy and to pay the proceeds in annual interest installments.[39] The court concluded that the legislative intent mandated the inclusion of the principal amount of the policy in the proceeds.[40] Since the installments were purely interest income and did not constitute the principal of the policy, the proceeds had to be included as gross income.

A somewhat different result was reached in *Jones v. United States*,[41] where the petitioner was the beneficiary of a life insurance policy issued to the deceased. Under the terms of the policy, the petitioner was to receive monthly installments of $106.80 for fifteen years.[42] Five years after the payments had commenced, the petitioner and the insurer agreed to reduce the monthly payments to $44.98, but extend the payments for the rest of petitioner's life. The court, looking to the substance of the agreement, held that the benefits existed wholly by reason of the death of the insured, and therefore, the form of the payments was not determinative.[43]

The final characteristic which must be present before a policy will be deemed an insurance contract within the meaning of section 101(a) is that

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37. Where the proceeds from life insurance policies are paid in the form of pure interest payments, section 101(c) of the Internal Revenue Code will govern. Life insurance policies whose proceeds are paid in installments, part of which are the principal and part of which are interest payments, are dealt with in section 101(d).

38. 21 T.C. 104 (1953).

39. Prior to the 1926 Act, the revenue acts did not specifically provide for the treatment of insurance proceeds when paid in installments. Under such earlier acts, the Treasury Department ruled that proceeds paid in installments were not subject to tax if they were paid under the terms of the policy, otherwise such installment payments were free from tax only until they aggregated the amount payable on the death of the insured. The statute was accordingly changed to read "in a single sum or in installments." Beginning with the 1934 Revenue Act, the term "or otherwise" was used in place of "in installments." The change was made so as to include proceeds of life insurance policies payable in the form of an annuity. *See* S. REP. No. 558, 73d Cong., 2d Sess. (1934).

40. The court, in considering policies where the proceeds were paid in installments, drew a distinction between cases where the installments included at least a portion of the principal and cases where the installments included no portion of the principal but were purely interest payments. The court concluded that while Congress may have intended to exclude the former from gross income, the court could not assume that Congress also intended to exclude the latter. *Id.* at 111.

In the 1954 Code, Congress has cleared up this ambiguity by dealing separately with installment payments which constitute part principal and part interest, and installment payments which constitute purely interest. *See* note 3 *supra*.

41. 222 F.2d 891 (7th Cir. 1955).

42. The court assumed that the installment payments constituted part principal and part interest. *Id.* at 897.

43. This case was decided under section 22(b) of the 1948 Code. Under the 1954 Code, the case would have been governed by section 101(d), which would require that the interest component of the installment payment be treated as income under section 61. *See* note 37 *supra*.

proceeds be more than simply employee death benefits.[44] An illustration of this requirement can be found in *Essenfeld v. Commissioner*,[45] in which the petitioner's husband, David, had entered into an employment agreement with Supreme Sunrise Food Exchange, Inc. (Supreme Sunrise). Part of the agreement provided that Supreme Sunrise: (1) at David's death, would pay the petitioner $25,000 per year for two years, or, (2) if David were incapacitated, would pay him (or if he subsequently died, his survivors) $25,000 per year for two years, or (3) if David retired upon completion of the contract term, would provide a retirement allowance. Supreme Sunrise then took out life insurance on David's life with a value of $75,000, naming itself beneficiary. A year later, David died, and Supreme Sunrise, under the terms of the employment agreement, paid the petitioner $25,000 in each of the next two years. In affirming a Tax Court decision upholding deficiency assessments by the I.R.S., the court held that since death was but one of three contingencies provided for in the agreement, the policy could not be called a life insurance contract within the statutory meaning of the term.[46] The court instead termed the proceeds "employees' death benefits."[47]

A similar result occurred in *Davis v. United States*,[48] where plaintiff, a widow of a judge, received death benefits from the West Virginia Judges' Retirement Fund. This fund was part of a retirement system established for judges by the West Virginia Legislature. The fund was comprised of contributions from the participating judges and by specific appropriations from the state legislature. The fund did not provide death benefits unless the judge was survived by his wife. The plaintiff's husband participated in this retirement system, contributing his required share. During the term of his service, the judge died, and the plaintiff received approximately $20,000 in benefits.

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44. Section 22(b)(1)(B) was added to the Internal Revenue Code in 1951. The legislative history of the provision indicates the following:

> Section 22(b)(1) of the code excludes from gross income amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise. However, by its terms, this provision is limited to life insurance payments, and the exclusion does not extend to death benefits paid by an employer by reason of the death of an employee. In order to correct this hardship, section 302 of your committee's bill excludes from gross income death benefits not in excess of $5,000 paid by any one employer with respect to any single employee's beneficiary or beneficiaries in accordance with a pre-existing contract. The limitation of the exclusion to payments not in excess of $5,000 will prevent abuses under this new provision.

S. Rep. No. 781, 82d Cong., 1st Sess. 50 (1951).

Under the 1954 Code, employees' death benefits are governed by section 101(b).

45. 311 F.2d 208 (2d Cir. 1962).

46. The court also noted that there was no shifting or distribution of the risk. *Id.* at 209. *See* text accompanying note 12 *supra*.

47. The court stated that, even if the arrangement could be termed a life insurance policy, it appeared more like an employees' death benefit which is specifically provided for in section 101(b). Since both a general and specific provision were applicable, the specific must control the general, and therefore, the proceeds must be considered employees' death benefits. *Id.*

48. 323 F. Supp. 858 (S.D.W. Va. 1971).

The court, finding the retirement system to be actuarily unsound due to the fact that it required annual legislative appropriations and that no benefits were received if a participant were predeceased by his spouse, held that the arrangement was not a life insurance contract under section 101(a) for which the proceeds would be excluded from gross income, but rather was in the nature of an employees' death benefit.[49]

In summary, in order to find the necessary characteristics of a life insurance contract, courts will require that the policy proceeds be paid only by reason of the insured's death, that the proceeds include the principal of the policy and that the life insurance policy be more than simply an employee's death benefit. When these life insurance characteristics are combined in a policy with the necessary insurance risk and insurable interest, courts will find a life insurance contract within the meaning of section 101(a). As a general rule, proceeds from life insurance contracts which meet these requirements will be excluded from gross income for federal income tax purposes.

II. The Transfer For Value Rule

Although a policy may satisfy the requirements of a life insurance contract whose proceeds are payable by death of the insured under section 101(a)(1), the proceeds may still not be totally excludible from gross income if the policy was transferred for valuable consideration.[50] In the case of such a transfer, the amount of proceeds excludible from a taxpayer's gross income is limited to the actual value of the consideration for the transfer plus any amounts, including premiums, paid by the transferee subsequent to the transfer.[51] This is termed the "transfer for value" rule.[52]

The major difficulty in interpreting this section lies in determining the meaning of the terms "transfer" and "valuable consideration." In this context, the term "transfer" means the creation of an enforceable contractual right to receive all or part of the proceeds from a life insurance policy.[53] These

49. The court also noted that there was no effective shifting or distribution of the risk since the plaintiff was not required to pay premiums. *Id.* at 861. For a case similar to *Davis* in facts and holding, *see* Laura v. Lilly, 45 T.C. 168 (1965).

50. I.R.C. § 101(a)(2). For the text of this section, *see* note 4 *supra*.

51. If the amount of consideration paid for the transfer plus the amounts paid subsequent to the transfer exceed the proceeds from the policy, the entire amount of the proceeds will be excluded from gross income. *See, e.g.*, Desks Inc., 18 T.C. 674 (1952); Charles E. Lambeth, 38 B.T.A. 351 (1938).

This formula for exclusion leads to some anomalous results. For example, if a life insurance contract with a face value of $10,000 was transferred gratuitously from the insured, the entire amount of proceeds would be excludible under section 101(a)(1). However, if this same life insurance contract was transferred for $1, then $9,999 would have to be included in the transferee's gross income under section 101(a)(2). Although courts could use their discretion in such cases, this dichotomy of result does not seem realistic.

52. *See generally* 1 J. Mertens, Law of Federal Income Taxation § 7.07 (Supp. 1978).

53. Treas. Reg. § 1.101-1(b)(4) (1978).

rights may arise by sale,[54] by assignment,[55] in a separate contract[56] or even by a distribution in liquidation.[57] A transfer for valuable consideration does not occur, however, where a policy is assigned or pledged solely as collateral security.[58] Nor does such a transfer occur where the exchange effects no significant change in beneficial ownership of the policies.[59] "Valuable consideration" may include a cash payment,[60] a stock transfer or sale,[61] an insurance contract subject to a policy loan[62] or even intangibles.[63] As can be seen by the diversity in the definitions of these two terms, the interpretation of the transfer for value rule requires a case-by-case analysis in order to determine whether there has actually been a transfer for valuable consideration.

The effect of the transfer for value rule is to exclude from gross income the amount of money necessary to cover the taxpayer's expenses incurred in obtaining the life insurance contract but to include any amount in excess of these costs. In order to fully understand this effect, it may be best to look at a simple example. Assume that A takes out a $10,000 life insurance contract on himself and later transfers the policy to B for $6,000. B subsequently pays premiums in the amount of $2,000. Upon the death of A, B receives proceeds in the amount of $10,000. The amount which B may exclude from his gross income is limited to the consideration ($6,000) plus the subsequent premiums paid ($2,000), a total of $8,000. The remaining $2,000 will be included in B's gross income.[64]

Three common situations where the transfer for value rule is applicable are stock transactions, debt and security transactions and transfers to trust funds.

A. *Stock Transactions*

Transfers of life insurance policies for valuable consideration often occur in transfers of stock in closely held corporations. A good example of such a transfer is *Monroe v. Patterson.*[65] In *Monroe*, a closely-held corporation, the

54. Treas. Reg. § 1.101-1(b)(5) (1978).

55. *Id.*

56. Monroe v. Patterson, 197 F. Supp. 146 (N.D. Ala. 1961).

57. Spokane Dry Goods Co., 1 T.C.M. (CCH) 921 (1943); Charles E. Lambeth, 38 B.T.A. 351 (1938).

58. Treas. Reg. § 1.101-1(b)(4) (1978).

59. Haverty Realty & Investment Co., 3 T.C. 161 (1944).

60. Treas. Reg. § 1.101-1(b)(5) (1978).

61. Monroe v. Patterson, 197 F. Supp. 146 (N.D. Ala. 1961); Charles E. Lambeth, 38 B.T.A. 351 (1938).

62. Rev. Rul. 69-187, 1969-1 C.B. 45.

63. Desks, Inc., 18 T.C. 674 (1952).

In order to find a transfer for valuable consideration, courts require that the consideration actually be paid. In a case where the instrument of transaction states that a certain consideration is to be paid, but the parties never intend to actually pay the consideration, courts will not apply section 101(a)(2). *See* Haverty Realty & Investment Co., 3 T.C. 161 (1944).

64. *See* Treas. Reg. § 1.101-1(b)(5) (ex. 1) (1978).

65. 197 F. Supp. 146 (N.D. Ala. 1961).

Alabama Engraving Company, had four stockholders: Ganster (72 ½ shares), Gore (55 shares), Monroe (45 shares) and Hickman (25 shares). The company purchased life insurance policies on Gore in the face amount of $10,000, naming itself beneficiary. The shareholders later entered into a restrictive share agreement whereby the policies were assigned to Ganster and Gore's estate to be held in trust and Gore, Monroe and Hickman each agreed to pay one-third of the premiums on the policies. Gore later died, and the proceeds from the life insurance policy ($12,146.84) were paid to the beneficiaries. In accordance with the agreement, it was decided that the company stock would be valued at $310.52 per share on the 127 ½ shares owned by Ganster and Gore. The 127 ½ shares were then sold to Monroe and Hickman at a total agreed price of $39,591.30. In accordance with the agreement, the proceeds from the life insurance policies were then applied to the stock purchase price, leaving a balance of $27,444.46. Monroe and Hickman each paid half of the balance and each received 63.75 shares of stock. The court found a transfer for valuable consideration in the mutuality of obligations in the agreement and the actual cash consideration paid by Monroe and Hickman in premiums.[66]

A similar result was reached in *Spokane Dry Goods Co.*[67] where the petitioner (Spokane) was a major stockholder in the Seattle Dry Goods Co. (Seattle). When Seattle began to lose money, Spokane felt it would be in its best interest to buy out Seattle's assets and liquidate them through Spokane's store. In accordance with this plan, Spokane purchased assets from Seattle in the amount of $152,715, including life insurance policies encumbered by policy loans. Spokane carried this sale on its books so that the gain or loss from the liquidation was to be computed on a cost basis of $152,715. Spokane later paid off the $30,000 loan on the policy and continued to pay the premiums as long as the policy was outstanding. The court found this constituted a transfer for valuable consideration due to the fact that Spokane paid $152,715 for Seattle's assets, part of which was for the life insurance policy, and because Spokane paid off the $30,000 loan on the policy.[68]

Another example of a transfer for valuable consideration in this context is found in *Charles E. Lambeth*,[69] where the petitioner and Eskridge organ-

66. The court also noted that the exclusion provisions of I.R.C. § 101(a)(2) are not as flexible in cases involving transfers from co-shareholders in a corporation as they are in cases involving a partner in a partnership. The section permits a transfer of a policy on the life of a shareholder or officer *to the corporation*, but it does not extend to a transfer of a policy from the corporation to a shareholder or officer, or a transfer between co-shareholders or co-officers. *Id.* at 149.

For the text of section 101(a)(2)(B), *see* note 4 *supra*. *See also* 1 J. Mertens, Law of Federal Income Taxation, Code Commentary, ch. 1(B) (Supp. 1978).

67. 1 T.C.M. (CCH) 921 (1943).

68. The court held that Spokane had the burden of proving the value of the consideration given for the policies. Since Spokane did not submit any evidence on this issue, the court sustained the commissioner's contention that valuable consideration was given. *Id.* at 925.

69. 38 B.T.A. 351 (1938).

ized a corporation to sell automobiles. Lambeth invested $75,000 in stock and Eskridge invested $15,000. The corporation took out two life insurance policies, one on Lambeth and one on Eskridge, with the corporation as beneficiary. Due to heavy losses, it was decided to liquidate the corporation. As part of the liquidation, it was resolved that Lambeth be substituted as the beneficiary of the life insurance policies. Lambeth was then required to pay the premiums on the policies in the future. After Eskridge's death, Lambeth collected $25,111.04 from the policy. The court held that the policies were transferred for valuable consideration, the consideration being the amount Lambeth paid for stock in the corporation. The court reasoned that this consideration was not only for the stock, but also for any distribution to which he might become entitled as a stockholder.[70]

A final example of a transfer for valuable consideration in the context of a stock transaction can be seen in *Desks, Inc.*[71] There, the petitioner (Desks) agreed to pay the premiums on a $60,000 life insurance policy belonging to Standard Furniture Company (Standard). In return, Standard agreed to buy merchandise on credit from Desks. Standard had obtained the life insurance policy from Hale Desk Company (Hale), a bankrupt corporation which owed Standard $60,102.14. Hale was run by many of the same officers and employees now with Desks. Subsequently, Hale paid back twenty percent of its debt to Standard, and in return, Standard agreed to remit to Desks $12,151.37 in life insurance proceeds. The court held that the entire amount of these proceeds was taxable to Desks,[72] finding a transfer for valuable consideration. The consideration in this case was the intangible benefit of Desks' business dealings with Standard.

As these cases point out, courts are not hesitant to find sufficient consideration in stock transactions. Moreover, courts will look to the substance of the transactions as a whole to determine whether a party has given anything of value in return for the proceeds of life insurance policies. If anything of value was given, the transfer for value rule will apply. Furthermore, in stock transactions, courts tend to view the proceeds as security against the risk of loss, rather than as benefits accruing because of death of the insured. Since security collateral is specifically included in gross income and is not protected by the general exclusion rule,[73] these cases appear to have been correctly decided.

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70. The court went on to note that since Lambeth paid $75,000 for the stock in the corporation and since it was unlikely that he would receive anything more than the $25,111.04 from the liquidation, the entire amount of the proceeds from the life insurance contract was excludible from his gross income. *Id.* at 355.

71. 18 T.C. 674 (1952).

72. The court noted that the premiums paid by Desks far exceeded the $12,151.33 it received, and therefore the entire amount of the proceeds from the life insurance policy was excludible from Desks' gross income. *Id.* at 681.

73. Treas. Reg. § 1.101-1(b)(4) (1978).

B. *Debt and Security Transactions*

Another area in which the transfer for value rule is commonly applied is in debt and security transactions. As mentioned earlier, if a policy is assigned purely for use as collateral security, the assignment is not considered to be within the scope of section 101.[74] However, where a life insurance policy is transferred to liquidate a debt, the valuable consideration element is deemed present, and section 101(a) will be applicable. The problem which often arises is in attempting to distinguish pure collateral situations from situations involving debt liquidation. Usually, the answer will depend upon the facts of the particular case. For example, in *Durr Drug Co. v. United States*,[75] Wylie was indebted to the appellant (Durr) for a sum in excess of $15,000. Durr convinced Wylie to take out life insurance in this amount, with the understanding that the policies would be delivered to Durr, who would pay the premiums. Prior to Wylie's death, Durr charged off as uncollectible $29,152.86 of Wylie's debt and claimed this amount as a tax deduction. When Wylie died, Durr collected the face value of the life insurance policies, but did not claim the amount as income. The government argued that this was a transfer for valuable consideration and, in fact, that there were two transactions: (1) Wylie's purchase of the insurance policies for himself and (2) a transfer of the policies for valuable consideration from Wylie to Durr, the consideration being the liquidation of the debt. The court, however, disagreed, stating that there was never a transfer at all, rather, from the inception until the maturity of the contract, Durr was the sole beneficiary and owner of the life insurance policy.[76]

A contrary result was reached in *T. O. McCamant*,[77] where Noill owed petitioner $21,092.34. McCamant deducted this amount as uncollectible debts, and took the appropriate tax deductions. Without notifying McCamant, Noill took out life insurance on his own life, naming McCamant beneficiary to the extent of his indebtedness to McCamant, and paid all premiums on the policy. After Noill's death, McCamant received $18,679.98 in proceeds from the policy. McCamant, relying on *Durr Drug*, claimed that the proceeds were excludible for tax purposes. The court disagreed, however, distinguishing the cases on the basis that in *Durr Drug* the beneficiary received the

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74. "[T]he pledging or assignment of a policy as collateral security is not a transfer for a valuable consideration of such policy or an interest therein, and I.R.C. § 101 is inapplicable to any amounts received by the pledgee or assignee." Treas. Reg. § 1.101-1(b)(4) (1978).

75. 99 F.2d 757 (5th Cir. 1938).

76. "The contention that we should find the two transactions equivalent and substitute the one which did not occur in fact, but which would be taxable, for the one which did occur in fact, but is not taxable within the plain language of the statute, disclosed its own fallacy." *Id.* at 759. Apparently, the court refused to find any relationship between the debt and the transfer of the policy. This raises serious doubt as to whether Durr had any insurable interest in Wylie. *See* text § I (B) *supra*.

77. 32 T.C. 824 (1959). *See also* Landfield Fin. Co. v. United States, 296 F. Supp. 1118 (N.D. Ill. 1968), *aff'd*, 418 F.2d 172 (7th Cir. 1969); Rev. Rul. 70-254, 1970-1 C.B. 31.

proceeds by reason of the debtor's death, while in this case McCamant received the proceeds by reason of Noill's indebtedness.[78]

A similar conclusion was reached in *St. Louis Refrigerating and Cold Storage Co. v. United States*,[79] where Walton was indebted to the plaintiff (St. Louis) in excess of $25,000, as evidenced by five promissory notes. Walton assigned three life insurance policies having a total face value of $25,000 to St. Louis as collateral security on the promissory notes. The interest of St. Louis as beneficiary was limited to the amount of Walton's indebtedness. St. Louis later charged off as uncollectible the debt of Walton and took tax deductions as a result. Sometime later, Walton died and St. Louis collected the net proceeds from the policies in the amount of $18,188.70. St. Louis, relying strongly on *Durr Drug*, claimed the proceeds were excludible from its gross income. The court, however, disagreed, finding that the insurance contract, when transferred and pledged, lost its character as insurance in the hands of the pledgee within the meaning of the statute, becoming simply collateral security. Since this was merely the recovery of a bad debt for which tax benefits had already been taken, the amount accruing to St. Louis had to be considered taxable income.

It appears that although the courts in *T.O. McCamant* and *St. Louis* attempted to distinguish the result arrived at in *Durr Drug*, these cases still involve irreconcilable holdings. It should also be noted, however, that all three cases were decided before 1954. The 1954 Code has attempted to clarify this discrepancy by expressly providing that the pledging or assignment of a policy as collateral security is not a transfer for valuable consideration of such policy, and that section 101 is inapplicable to any amounts received by the pledgee or assignee.[80]

As a result of the discrepancies between the holdings in *Durr Drug* and *T.O. McCamant* and *St. Louis*, and the attempted clarification by the 1954 Code, it now appears that where a life insurance contract is transferred for valuable consideration in a collateral security situation, section 101 will be totally inapplicable. In this regard, the regulations take the approach that, upon the exchange, the policy loses its character as a life insurance contract and becomes a simple transfer of contractual rights.[81] This situation, of course, must be distinguished from a debt liquidation situation, in which the transfer for value rule would be applicable. Unfortunately, this distinction is not always easily drawn, and will likely depend upon a factual determination as to whether the transferred life insurance policy was the consideration for

78. In *Durr*, "the beneficiary had only to submit proof of death to the insurer in order to be entitled to the benefits of the contract. In the case before us — no debt, no payment. This distinction between *Durr* and the instant case is vital." 32 T.C. at 835.

79. 66 F. Supp. 62 (E.D. Mo. 1946), *aff'd*, 162 F.2d 394 (8th Cir. 1947). *See also* Waynesboro Knitting Co., 23 T.C. 404 (1954), *aff'd*, 225 F.2d 447 (3d Cir. 1955); Federal Nat'l Bank of Shawnee, Okla., 16 T.C. 54 (1951).

80. *See* Treas. Reg. § 1.101-1(b)(4) (1978).

81. *Id.*

the debt liquidation or whether the policy was simply being held as security until other consideration was paid to liquidate the debt.

C. *Transfers to Trust Funds*

The third area in which the transfer for value rule will generally be applicable concerns the transfer of life insurance policies to trust funds. Application of the rule in this context is illustrated by a situation in which an employer and employee agreed to provide a trust whereby the employer could purchase existing life insurance policies from the employee.[82] The employer, in turn, would use this trust fund to provide the employee with a qualified pension plan with incidental death benefits. The employee died, and, as required by the terms of the plan, the insurance proceeds were paid to the trustee. The trustee then turned the proceeds over to the insured's widow, who was the beneficiary. The Commissioner ruled that since there was no absolute transfer of the right to receive all or part of the proceeds of the life insurance policy, the arrangement affected no significant change in the beneficial ownership of the proceeds of the life insurance policy, and therefore, the transfer was not made for valuable consideration within the purview of section 101(a)(2).[83]

In a similar situation, a corporation maintained a qualified profit sharing plan that permitted voluntary employee cash contributions.[84] In lieu of voluntary cash contributions, the plan allowed a participating employee to assign life insurance contracts having cash surrender values as his voluntary contribution to the exempt trust forming part of the plan. Under the terms of the plan, the proceeds of the contract continued to be payable to the employee's beneficiaries. The Commissioner, following the same line of reasoning as in the Revenue Ruling discussed above, determined that the proceeds from such a transfer did not constitute a transfer for valuable consideration under section 101(a)(2).

These rulings appear to be consistent with the general philosophy behind the transfer for value rule. Since the "absolute contractual right" to the proceeds never shifted from the beneficiary, there is no real transfer at all. The proceeds from these policies will be totally excludible under section 101(a). The difference between these cases and simple death benefits[85] is that in these situations, the right to the proceeds is absolute and never shifts from the beneficiary, while in death benefit cases there is no absolute right to the proceeds. Where this distinction is not clear, courts will apparently look to the substance of the arrangement to make their determination.

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82. Rev. Rul. 73-338, 1973-2 C.B. 20.
83. *Id.* at 21.
84. Rev. Rul. 74-76, 1974-1 C.B. 30.
85. I.R.C. § 101(b).

D. *Practical Considerations*

The significance of the transfer for value rule is clear: carelessly assigning the proceeds from a life insurance contract could easily trigger an unexpected tax liability. To avoid this additional tax liability, one must be careful when utilizing life insurance contracts in business or personal affairs. Basically, avoiding the adverse effect of the transfer for value rule may be accomplished in two ways. First, one should structure the transaction so that the contractual right to the proceeds does not shift from the beneficiary. This would avoid any "transfer" as defined by the courts. Second, one should structure transaction so that nothing of value is given in return for the right to the proceeds from the life insurance contract. Since courts view "valuable consideration" very strictly, the right to the proceeds must essentially be totally gratuitous in order to avoid the tax liability of section 101(a)(2). Where the "transfer" element or the "valuable consideration" element is missing from a transaction, courts will not apply the transfer for value rule and no unexpected tax liability will accrue.

IV. I.R.C. Sections 101(a)(2)(A) & (B) — Exceptions to the Exception

There are two situations where proceeds from life insurance contracts payable by reason of death of the insured which are transferred for valuable consideration will still be completely excludible from the taxpayer's gross income. These are exceptions to the transfer for value rule. Further complications arise when there is a series of transfers and when there is a gratuitous transfer.

A. *Section 101(a)(2)(A)*

If a life insurance contract has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to the basis of such contract in the hands of the transferor, the proceeds from such contract will be wholly excludible from gross income.[86]

This exception to the transfer for value rule was adopted in 1942. Consistent with the legislative intent behind this exception,[87] the transfer of life insurance policies in tax-free reorganizations of corporations or in gratuitous transfers will not be burdened by additional tax liability. This exception is in line with the theory behind the general exclusionary purpose of section 101(a), the protection from tax of the proceeds of life insurance policies which have been transferred for legitimate business purposes. Seldom is such a transfer made for purely speculative reasons, the rationale for the imposition of tax liability. Rather, the legislature has recognized that in these situations, the policies are usually transferred for legitimate business purposes, and has

86. I.R.C. § 101(a)(2)(A). For the text of this section, *see* note 4 *supra*.

87. S. Rep. No. 1631, 77th Cong., 2d Sess. 697 (1942); H.R. Rep. No. 2586, 77th Cong., 2d Sess. 36 (1942).

therefore excluded proceeds of this nature.[88]

To fully understand the effect of this exception to the transfer for value rule, it may be helpful to consider a simple example. Assume the Alpha Corporation pays premiums of $5,000 for a life insurance policy in the face amount of $10,000 upon the life of one of its employees, naming itself beneficiary. The Alpha Corporation subsequently transfers this policy to the Beta Corporation in a tax-free reorganization.[89] The Beta Corporation receives the proceeds in the amount of $10,000 upon the death of the employee. Since the policy had a basis for determining gain or loss in the hands of the Beta Corporation determined by reference to its basis in the hands of the Alpha Corporation, the entire $10,000 is to be excluded from the gross income of the Beta Corporation.[90]

An illustration of this exception is seen in *James F. Waters, Inc. v. Commissioner*.[91] In *Waters*, an individual took out certain life insurance policies on his own life and later transferred the policies to a corporation which he controlled, in consideration for the cash surrender value minus the current premiums. Sometime later, this corporation merged with the taxpayer (Waters, Inc.) and the policies became the property of the latter as a matter of law. Neither corporation recognized any gain or loss from the transfer. Upon the death of the insured, Waters, Inc. received in excess of $141,000 from the policies. Waters, Inc. claimed that these proceeds were excludible from gross income since the insurance policy had a basis for determining gain or loss to the transferee determined by reference to such basis in the hands of the transferor. Although the proceeds were held to be includible in gross income for other reasons,[92] the court recognized the applicability of this exception to the transfer for value rule to the original transaction.

A more recent application of section 101(a)(2)(A) occurred in *Estate of Rath v. United States*.[93] Rath, owner of 12,143 shares of common stock in the J.B. Rath Co. (Rath Co.), entered into an agreement with Rath Co. whereby the company agreed to purchase life insurance on Rath, the proceeds of which were to be used by the company to purchase Rath's stock in the event of his

88. S. Rep. No. 1622, 83d Cong., 2d Sess. 14 (1954).

89. Prior to 1942, all transactions involving "tax-free" reorganizations of corporations were considered to be transfers for valuable consideration. *See* King Plow Co. v. Comm'r, 110 F.2d 649 (5th Cir. 1940); Stroud & Co., 45 B.T.A. 862 (1941).

After 1942, "tax-free" reorganizations were held to be exceptions to the transfer for value rule. *See* S. Rep. No. 1631, 77th Cong., 2d Sess. 69 (1942); H.R. Rep. No. 2586, 77th Cong., 2d Sess. 36 (1942).

90. *See* Treas. Reg. § 1.101-1(b)(5) (ex. 2) (1978).

91. 160 F.2d 596 (9th Cir. 1947).

92. The court in *Waters* held that the legislative history of this exception (*see* note 89 *supra*) makes it clear that it should only apply to the first transfer, and not to subsequent transfers. 160 F.2d at 597.

It appears that the court was mistaken as to this contention, however, since the legislature soon after clarified that the exception should apply to such a factual situation. I.R.C. § 101(a)(2)(B) (1978). *See* Treas. Reg. § 1.101-1(b)(5) (ex. 5) (1978).

93. 77-1 U.S.T.C. (CCH) ¶ 9,327 (1977).

death. The agreement also provided that Rath would have the right to acquire these policies in the event that he ceased to be a stockholder. Sometime later, Rath sold his stock in Rath Co. to another corporation. Rath directed that his interest in the policy be assigned to his wife. Consistent with this direction, Rath Co. transferred the policy to Rath's wife in consideration of $11,600 in funds which were, in fact, given to her by Rath. Rath later died, his wife collecting $100,000 in insurance proceeds. In support of her claim that the proceeds should be excludible from gross income, the plaintiff (Rath's wife) claimed that there was a simultaneous transfer from Rath Co., and Rath to her. She argued that the transfer was partly for consideration ($11,600) and partly gratuitous, since she paid nothing to Rath for the value of the policy in excess of $11,600.[94] Since her basis would then be determinable in part from that of Rath, the exception of Section 101(a)(2)(A) would apply. The court agreed, holding that the entire proceeds were exempt from federal income tax liability.

As pointed out by *Waters* and *Rath*, an exception to the transfer for value rule occurs when the basis of the transferee is determined in whole or in part by reference to the basis of such contract in the hands of the transferor. This exception usually arises in the situation of a tax-free incorporation or a gratuitous transfer. However, as pointed out later, further complications arise when there are a series of transfers.[95]

B. *Section 101(a)(2)(B)*

The second situation in which the transfer for value rule will not apply occurs where a life insurance contract is transferred 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.[96]

An example of the application of this exception is found in the *Rath* case mentioned previously.[97] In *Rath*, the plaintiff, as an alternative theory for recovery, argued that Rath was an integral part of the transfer. She viewed the transfer as a two-step transaction. In the first step, Rath Co. transferred the policy to Rath for $11,600. Although this was clearly a transfer for valuable consideration, the transfer fell within the section 101(a)(2)(B) exception to the rule, since the policy was transferred to the insured. As such, the proceeds from the policy were totally excludible from Rath's gross income. The second step of the transaction was a gratuitous transfer from the insured to the plaintiff. Such a transfer is clearly protected under section 101.[98]

Another illustration of this exception is found in *Swanson v.*

94. The actual value of the policy was a great deal more than the consideration paid ($11,600). *Id.*

95. *See* text §§ III (C) and (D) *infra.*

96. For the text of § 101(a)(2)(A), *see* note 4 *supra.*

97. Estate of Rath v. United States, 77-1 U.S.T.C. (CCH) ¶ 9,327 (1977). *See* text § III (A) *supra.*

98. *See* text § III (D) *infra.*

Commissioner.[99] W.C. Swanson's mother originally created a trust which was later transferred to Swanson as a trustee for each of his three children. A few months later, Swanson resigned and appointed Johnson to replace him as trustee. Swanson also provided that the trustee would have the power to become a general or limited partner on behalf of the trusts. Sometime later, Swanson, on his own behalf, and Johnson, as trustee, entered a partnership agreement. Under the partnership agreement, the Swanson trusts were to contribute life insurance policies on the life of Swanson having face values of $1,900,000. These policies were originally owned by C.A. Swanson & Sons, a Nebraska corporation, the stock of which was partially owned by W. C. Swanson. C.A. Swanson & Sons was later purchased by the Campbell Soup Company, at which time the policies were purchased by the Carl and Caroline Swanson Foundation, Inc. The Swanson Trusts later purchased the policies from the Foundation. Upon the death of Swanson, the Trusts received $913,954.09 in proceeds from the policies. In support of its contention that these proceeds fell within section 101(a)(2)(B), the petitioners argued that the policies were transferred to a partnership in which the insured (W.C. Swanson) was a partner. The court, however, looking past the form to the substance of the agreement, found that the partnership did not act as a "viable partnership,"[100] and therefore did not satisfy the statutory intent of section 101(a)(2)(B).

Although this exception seems quite clear on its face, the Swanson case is a reminder that, for tax purposes, courts will always look to the substance of the arrangement. If the arrangement was made for legitimate business purposes, courts will allow the exception to control. If the arrangement is made simply to avoid tax liability, courts are not hesitant to ignore the form of the relationship and will not allow the exception to stand.

C. *Series of Transactions*

Even where a factual situation appears to clearly satisfy one of the exceptions to the transfer for value rule, courts will view the transactions as a whole. If the substance of a transaction is contrary to its form, complications may arise. An example of such a complication occurs in a situation involving a series of transactions. The general rule in such a case is that if the last transfer is for a valuable consideration, the transfer for value rule applies.[101] In this situation, the exclusion is limited to the sum of the actual consideration paid for the last transfer and any subsequent payments. However, if the last transfer 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 final transferee shall exclude the entire amount of the proceeds from gross income. If such is not the case, and the policy has a

99. 518 F.2d 59 (8th Cir. 1975). *Accord*, Rev. Rul. 69-187, 1969-1 C.B. 45.

100. 518 F.2d at 62.

101. *See* Treas. Reg. § 1.101-1(b)(3) (1978).

basis for determining gain or loss in the hands of the final transferee determined in whole or in part with reference to the basis of such policy in the hands of the transferor, the exclusion is limited to the amount which would have been excludible by his tranferor if no such transfer had taken place, plus any subsequent payments by the transferee.[102]

A few examples may help to clarify these rules. Assume that the Alpha Company makes premium payments in the amount of $5,000 for a life insurance policy on one of its employees, naming itself beneficiary. The Alpha Company later transfers the policy to the Beta Company in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Beta Company determined by reference to its basis in the hands of the Alpha Company). The Beta Company later transfers the policy to the Delta Company for a cash payment of $6,000. The Delta Company subsequently pays premiums of $2,000 on the policy. Upon the death of Alpha Company's employee, the Delta Company receives proceeds in the amount of $10,000. Since the final transfer was for a cash consideration, the transfer for value rule applies and the Delta Company may only exclude the consideration paid ($6,000) plus any subsequent payments ($2,000) for a total of $8,000 of the $10,000 received. The balance of $2,000 must be included in the Delta Company's gross income.[103]

Assume further that the facts are the same as in the preceding paragraph except that prior to the death of the insured, the Delta Company transfers the policy to the Phi Company in a tax-free reorganization. The Phi company makes further premium payments in the amount of $1,000. Upon the death of the insured, the amount which the Phi Company may exclude from its gross income is limited to the basis of the Delta Company ($8,000) plus the subsequent payments made by the Phi Company ($1,000) for a total of $9,000.[104]

Another application of this rule occurs where the facts are the same as in the preceding paragraph except that prior to the death of the insured, the Phi Company transfers the policy for a cash payment of $9,000 to the Omega Company. The insured is a shareholder of the Omega Company. Upon the death of the insured, the Omega Company may exclude the entire $10,000 proceeds from its gross income.[105]

Although a series of transactions can become quite complicated, the applicable rule is rather simple. Whenever any transfer is for valuable consideration, the transfer for value rule will apply unless it is superceded by one of the exceptions. However, where section 101(a)(2)(A) is applicable, the exclusion is limited to the tranferor's basis plus subsequent payments. The rationale behind the rule (prohibition of tax avoidance through a simple gratuitous transfer) is sound.

102. *Id.*
103. *See* Treas. Reg. § 1.101-1(b)(5) (ex. 3) (1978).
104. *See* Treas. Reg. § 1.101-1(b)(5) (ex. 4) (1978).
105. *See* Treas. Reg. § 1.101-1(b)(5) (ex. 5) (1978).

D. *Gratuitous Transfers*

While the rule just mentioned appears clear, its subtle ramifications require more discussion. The general rule in a situation involving a gratuitous transfer is that the amount of the proceeds excludible from gross income will be limited to the amount which would have been excludible had no transfer taken place plus any payments made by the transferee subsequent to the transfer.[106] Obviously, if the transferor is the insured, the entire amount of the proceeds will be excludible from the transferee's gross income. Furthermore, if the gratuitous transfer 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 proceeds will come under the purview of section 101(a)(2)(B), and therefore, would be totally excludible. If such is not the case, however, the gratuitous transfer is treated as a transfer for valuable consideration.

Again, a few examples may help to clarify the rule. Assume that Al pays premiums of $2,000 for a life insurance policy with a face value of $10,000 on his own life. Al later transfers the policy to his wife, Betty, for $3,000. Betty later gives the policy to her son, Chuck, who makes premium payments in the amount of $1,000. Upon the death of Al, Chuck receives the proceeds from the policy in the amount of $10,000. The amount which Chuck may exclude from his gross income is limited to Betty's basis ($3,000) plus subsequent payments made by himself ($1,000) for a total of $4,000. The balance of the proceeds ($6,000) must be included in Chuck's gross income.[107] However, if Chuck, prior to Al's death, had given the policy back to Al (the insured), upon the death of Al, his estate would have been able to exclude the entire amount of the proceeds, based on the section 101(a)(2)(A) exception discussed in section IV(A).[108]

This type of situation occurred in *Alcy Sivyer Hacker*,[109] where the petitioner's father took out a life insurance policy with a face value of $10,000 on his own life, naming a corporation as beneficiary. Sometime later, the beneficiary was changed to the insured's wife, the petitioner's mother. Later, the insured transferred all his rights in the policy to his wife for $730. The insured's wife made subsequent premium payments of $935.10 and then assigned the policy to the petitioner, her daughter, for "natural love and affection." Upon the death of the insured, the petitioner received the face value of the policy. The court, citing the fact that the petitioner was gratuitously assigned the policy, looked to the basis of the assignee, the petitioner's mother. Since the petitioner's mother purchased the policy for valuable consideration, the transfer for value rule applied, and the petitioner was limited in the amount she could exclude from her gross income to $8,626.35, repre-

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106. *See* Treas. Reg. § 1.101-1(b)(2) (1978).
107. *See* Treas. Reg. § 1.101-1(b)(5) (ex. 6) (1978).
108. *See* text § III (A) *supra*; Treas. Reg. § 1.101-1(b)(5) (ex. 7) (1978).
109. 36 B.T.A. 659 (1937).

senting the excess of the proceeds of the policy over the amount paid by petitioner's mother in the assignment of the policy to the petitioner, plus premiums paid.

The "series of transfers" and "gratuitous transfers" rules are consistent with the legislative intent behind the general exclusion rule for life insurance proceeds. If the proceeds are to provide benefits to the survivors of the insured or are used for legitimate business purposes, the proceeds are shielded from federal income tax liability. If the life insurance policies are transferred for other reasons, this protection does not apply.

E. *Practical Considerations*

Perhaps the best way of avoiding the additional tax liability imposed by the transfer for value rule is to structure the transaction so that either (1) the transfer of the life insurance contract 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 or (2) the life insurance contract has a basis in the hands of the transferee determined in whole or in part by reference to the transferor's basis in the policy. In either of these two situations, the proceeds will be totally excludible notwithstanding the applicability of the transfer for value rule.

It should be remembered, however, that the transfer must be a bona fide transaction rather than just a "paper" transaction, since the courts will look past the form of the arrangement to its substance.[110] Also, where there is a series of transactions and the final transfer would normally fall within section 101(a)(2)(A),[111] the proceeds will not be totally excludible, but rather, the rationale of the transfer for value rule will apply.[112]

In order to avoid additional tax liability where a transfer for value has already occurred, the life insurance contract should be re-transferred to one of the entities listed in section 101(a)(2)(B). As long as the entity is a viable one and not one created merely for the purpose of avoiding the effect of the transfer for value rule, the proceeds will again be totally excluded from the transferee's gross income.[113] This is true even though the second transfer is for valuable consideration and even though the transfer was made simply to avoid the tax consequences.[114]

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110. *See* note 10 *supra*.

111. An example of this is a series of transfers in which the last transfer is gratuitous.

112. In such a situation, the amount excludible is limited to the amount which would have been excludible by the transferor if no such transfer had taken place, plus any subsequent payments made by the transferee. *See* Treas. Reg. § 1.101-1(b)(2) (1978).

113. I.R.C. § 101(a)(2)(B).

114. *See, e.g.*, Estate of Rath v. United States, 77-1 U.S.T.C. (CCH) ¶ 9,327 (1977). However, neither the Tax Court nor the Service is bound by the form of the transaction. *E.g.*, Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

IV. *Conclusion*

In analyzing the transfer for the value rule of section 101(a), one must first determine whether the life insurance contract has satisfied the language and intent of section 101(a)(1). This requires that the policy involve an insurable interest, an insurance risk and other life insurance characteristics. Under the transfer for value rule, if such a life insurance contract is transferred for a valuable consideration, the proceeds will not be totally excludible, but rather, the exclusion will be limited to the actual value of the consideration plus any payments subsequent to the transfer. However, even if the transfer for value rule would normally apply, where the transfer 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, or where the life insurance contract has a basis in the hands of the transferee determined in whole or in part by the basis of the transferor, the proceeds will still be totally excludible.

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