



[CLICK HERE to return to the home page](#)

Treas. Reg. Section 1.101-1(f)(5)

Exclusion from gross income of proceeds of life insurance contracts payable by reason of death

(a)

(1) In general. Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient. Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, issued on or before December 31, 1984, are covered by this provision. The exclusion from gross income allowed by section 101(a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101(a)(2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101(c) (relating to amounts held under agreements to pay interest) or section 101(d) (relating to amounts payable at a date later than death). See §§1.101-3 and 1.101-4. However, neither section 101(c) nor section 101(d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death. If the life insurance contract is an employer-owned life insurance contract within the definition of section 101(j)(3), the amount to be excluded from gross income may be affected by the provisions of section 101(j).

(2) Cross references. For rules governing the taxability of insurance proceeds constituting benefits payable on the death of an employee-

(i) Under pension, profit-sharing, or stock bonus plans described in section 401(a) and exempt from tax under section 501(a), or under annuity plans described in section 403(a), see section 72(m)(3) and paragraph (c) of §1.72-16;

(ii) Under annuity contracts to which §1.403(b)-3 applies, see §1.403(b)-7. For the definition of a life insurance company, see section 801; or

(iii) Under eligible State deferred compensation plans described in section 457(b), see paragraph (c) of §1.457-1.

(b) Transfers of life insurance policies.

(1) Transfer of an interest in a life insurance contract for valuable consideration.

(i) In general. In the case of a transfer of an interest in a life insurance contract for valuable consideration, including a reportable policy sale for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited under section 101(a)(2) to the sum of the actual value of the consideration for the transfer paid by the transferee and the premiums and other amounts subsequently paid by the transferee with respect to the interest. For exceptions to this general rule for certain transfers for valuable consideration that are not reportable policy sales, see paragraph (b)(1)(ii) of this section. The application of section 101(d), (f) or (j), which is not addressed in paragraph (b) of this section, may further limit the amount of the proceeds excludable from gross income.

(ii) Exceptions.

(A) Exception for carryover basis transfers. The limitation described in paragraph (b)(1)(i) of this section does not apply to the transfer of an interest in a life insurance contract for valuable consideration if each of the following requirements are satisfied. First, the transfer is not a reportable policy sale. Second, the basis of the interest, for the purpose of determining gain or loss with respect to the transferee, is determinable in whole or in part by reference to the basis of the interest in the hands of the transferor (see section 101(a)(2)(A)). Third, paragraph (b)(1)(ii)(B) of this section does not apply. In the case of a transfer described in this paragraph (b)(1)(ii)(A), the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee with respect to the interest. The preceding sentence applies without regard to whether the interest previously has been transferred and the nature of any prior transfer of the interest.

(B) Exception for transfers to certain persons.

(1) In general. The limitation described in paragraph (b)(1)(i) of this section does not apply to the transfer of an interest in a life insurance contract for valuable consideration if both of the following requirements are satisfied. First, the transfer is not a reportable policy sale and the interest was not previously transferred for valuable consideration in a reportable policy sale. Second, the interest is transferred to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (see section 101(a)(2)(B)).

(2) Transfers to certain persons subsequent to a reportable policy sale. Except as provided in paragraph (b)(1)(ii)(B)(3) of this section, if a transfer of an interest in a life insurance contract would be described in paragraph (b)(1)(ii)(B)(1) of this section, but for the fact that the interest previously was transferred for valuable consideration in a reportable policy sale (whether in the

immediately preceding transfer or an earlier transfer), then the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of-

- (i) The higher of the amount that would have been excludable by the transferor if the transfer had not occurred or the actual value of the consideration for the transfer paid by the transferee; and

- (ii) The premiums and other amounts subsequently paid by the transferee with respect to the interest.

(3) Transfers to the insured subsequent to a reportable policy sale.

- (i) Except as provided in paragraph (b)(1)(ii)(B)(3)(ii) of this section, to the extent that an interest (or portion of an interest) in a life insurance contract that was transferred for valuable consideration in a reportable policy sale subsequently is transferred to the insured for valuable consideration, the limitations described in paragraph (b)(1)(i) of this section and paragraph (b)(1)(ii)(B)(2) of this section do not apply. To the extent that fair market value is not paid by the insured for the transferred interest, the transfer of the portion of the interest with a value in excess of the consideration paid will be treated as a gift under the bargain sale rule in paragraph (b)(2)(iii) of this section.

- (ii) This paragraph (b)(1)(ii)(B)(3)(ii) applies with respect to an interest described in paragraph (b)(1)(ii)(B)(3)(i) of this section (or portion of such an interest) that subsequently is transferred by the insured to any other person. If all subsequent transfers of the interest (or portion of the interest) are gratuitous transfers that are not reportable policy sales, the amount of the proceeds excluded from gross income is determined under paragraph (b)(2)(i) of this section, taking into account the application of paragraph (b)(1)(ii)(B)(3)(i) of this section to the insured's acquisition of the interest. If any subsequent transfer of the interest (or portion of the interest) is for valuable consideration or is a reportable policy sale, the amount of the policy proceeds excludable from gross income is determined in accordance with paragraph (b) of this section; if the amount that would have been excludable from gross income by the insured following the transaction described in paragraph (b)(1)(ii)(B)(3)(i) of this section if no subsequent transfer had occurred is relevant, that amount is determined under paragraph (b)(1)(ii)(B)(2) of this section. Paragraph (g)(8) (Example 8) of this section

and paragraph (g)(9) (Example 9) of this section illustrate the application of this paragraph (b)(1)(ii)(B)(3)(ii).

(2) Other transfers.

(i) Gratuitous transfer of an interest in a life insurance contract. To the extent that a transfer of an interest in a life insurance contract is gratuitous, including a reportable policy sale that is not for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount of the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee with respect to the interest. However, if an interest in a life insurance contract is transferred gratuitously to the insured, and that interest has not previously been transferred for value in a reportable policy sale, the entire amount of the proceeds attributable to the interest transferred to the insured is excludable from gross income.

(ii) Partial transfers. When only part of an interest in a life insurance contract is transferred, the transferor's exclusion is ratably apportioned between or among the several parts. If multiple parts of an interest are transferred, the transfer of each part is treated as a separate transaction, with each transaction subject to the rule under paragraph (b) of this section that is applicable to the type of transfer involved.

(iii) Bargain sales. When the transfer of an interest in a life insurance contract is in part a transfer for valuable consideration and in part a gratuitous transfer, the transfer of each part is treated as a separate transaction for purposes of determining the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1). Each separate transaction is subject to the rule under paragraph (b) of this section that is applicable to the type of transfer involved.

(3) Determination of amounts paid by the transferee. For purposes of paragraphs (b)(1) and (2) of this section, in determining the amounts, if any, of consideration paid by the transferee for the transfer of an interest in a life insurance contract and premiums and other amounts subsequently paid by the transferee with respect to that interest, the amounts paid by the transferee are reduced, but not below zero, by amounts received by the transferee under the life insurance contract that are not received as an annuity, to the extent excludable from gross income under section 72(e).

(c) Reportable policy sale.

(1) In general. Except as provided in paragraph (c)(2) of this section, a reportable policy sale for purposes of this section and section 6050Y is any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract.

(2) Exceptions. None of the following transactions is a reportable policy sale:

(i) A transfer of an interest in a life insurance contract between entities with the same beneficial owners, if the ownership interest of each beneficial owner in the transferor entity does not vary by more than a 20 percent ownership interest from that beneficial owner's ownership interest in the transferee entity. In a series of transfers, the prior sentence is applied by comparing the beneficial owners' ownership interest in the first transferor entity and the last transferee entity. For purposes of this paragraph (c)(2)(i), each beneficial owner of a trust is deemed to have an ownership interest determined by the broadest possible exercise of a trustee's discretion in that beneficial owner's favor. Paragraph (g)(13) (Example 13) of this section provides an illustration of the application of this paragraph (c)(2)(i).

(ii) A transfer between corporations that are members of an affiliated group (as defined in section 1504(a)) that files a consolidated U.S. income tax return for the taxable year in which the transfer occurs.

(iii) The indirect acquisition of an interest in a life insurance contract by a person if-

(A) A partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and §1.6050Y-2; or

(B) Immediately before the acquisition, no more than 50 percent of the gross value of the assets (as determined under paragraph (f)(4) of this section) of the partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract, and in which an ownership interest is being directly acquired, consists of life insurance contracts, provided that, after the acquisition, with respect to that partnership, trust, or other entity, the person indirectly acquiring the interest in the life insurance contract and his or her family members own, in the aggregate-

(1) With respect to an S corporation, stock possessing 5 percent or less of the total combined voting power of all classes of stock entitled to vote and 5 percent or less of the total value of shares of all classes of stock of the S corporation;

(2) With respect to a trust or decedent's estate, 5 percent or less of the corpus and 5 percent or less of the annual income (taking into account, for the purpose of determining any person's ownership interest, the maximum amount of income and corpus that could be distributed to or held for the benefit of that person); or

(3) With respect to a partnership or other entity that is not a corporation or a trust, 5 percent or less of the capital interest and 5 percent or less of the profits interest.

(iv) The acquisition of a life insurance contract by an insurance company that issues a life insurance contract in an exchange pursuant to section 1035.

(v) The acquisition of a life insurance contract by a policyholder in an exchange pursuant to section 1035, if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange.

(d) Substantial relationship.

(1) Substantial family relationship. For purposes of this section, a substantial family relationship means the relationship between an individual and any family member of that individual as defined in paragraph (f)(3) of this section. In addition, a substantial family relationship exists between an individual and his or her former spouse with regard to the transfer of an interest in a life insurance contract to (or in trust for the benefit of) that former spouse incident to divorce.

(2) Substantial business relationship. For purposes of this section, a substantial business relationship between the insured and the acquirer exists in each of the following situations:

(i) The insured is a key person (as defined in section 264) of, or materially participates (within the meaning of section 469) in, an active trade or business as an owner, employee, or contractor, and at least 80 percent of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer.

(ii) The acquirer acquires an active trade or business and acquires the interest in the life insurance contract either as part of that acquisition or from a person owning significant property leased to the acquired trade or business or life insurance policies held to facilitate the succession of the ownership of the business if-

(A) The insured-

(1) Is an employee within the meaning of section 101(j)(5)(A) of the acquired trade or business immediately preceding the acquisition (for purposes of this paragraph (d)(2)(ii)(A)(1), however, the reference in section 101(j)(5)(A) to highly compensated employee within the meaning of section 414(q) does not include a former employee); or

(2) Was a director, highly compensated employee, or highly compensated individual within the meaning of section 101(j)(2)(A)(ii) of the acquired trade or business, and the acquirer, immediately after the acquisition, has ongoing financial obligations to the insured with respect to the insured's employment by the trade or business (for example, the life insurance contract is maintained by the acquirer to fund current or future retirement, pension, or survivorship obligations based on the insured's relationship with the entity or to fund a buy-out of the insured's interest in the acquired trade or business); and

(B) The acquirer either carries on the acquired trade or business or uses a significant portion of the acquired business assets in an active trade or

business that does not include investing in interests in life insurance contracts.

(3)Substantial financial relationship. For purposes of this section, a substantial financial relationship between the insured and the acquirer exists in each of the following situations:

(i) The acquirer (directly or indirectly, through one or more partnerships, trusts, or other entities of which it is a beneficial owner) has, or the beneficial owners of the acquirer have, a common investment (other than the interest in the life insurance contract) with the insured and a buy-out of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable.

(ii) The acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets of or to satisfy liabilities of the insured or the insured's estate, heirs, legatees, or other successors in interest, or to satisfy other liabilities arising upon or by reason of the death of the insured.

(iii) The acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received from the insured either financial support in a substantial amount or significant volunteer support or that meets other requirements prescribed in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) for establishing that a substantial financial relationship exists between the insured and the organization.

(4)Special rules. Paragraphs (d)(4)(i), (ii), and (iii) of this section apply for purposes of determining whether a substantial relationship (whether family, business, or financial) exists under paragraph (d)(1), (2), or (3) of this section, respectively.

(i) Indirect acquisitions. The acquirer of an interest in a life insurance contract in an indirect acquisition is deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the acquirer acquires its interest.

(ii) Acquisitions by certain persons. The sole fact that an acquirer is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, is not sufficient to establish a substantial business or financial relationship with the insured. In addition, an acquirer need not be a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer to have a substantial business or financial relationship with the insured.

(iii) Acquisitions by those with differing types of substantial relationships. A substantial family, business, or financial relationship exists between the insured and a partnership, trust, or other entity if each beneficial owner of that partnership, trust, or other entity has a substantial family, business, or financial relationship with the insured. For example, a substantial family, business, or financial relationship exists between the insured and a trust if each trust

beneficiary is a family member of the insured or an organization described in paragraph (d)(3)(iii) of this section.

(e)Interest in a life insurance contract.

(1)Definition. For purposes of this section and section 6050Y, the term interest in a life insurance contract means the interest held by any person that has taken title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes, including any person that has taken title or possession as nominee for another person, and the interest held by any person that has an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other economic benefits of the policy as described in §20.2042-1(c)(2) of this chapter, such as the enforceable right to designate a contract beneficiary. Any person named as the owner in the life insurance contract generally is the owner (or an owner) of the contract and holds an interest in the contract.

(2)Transfer of an interest in a life insurance contract. For purposes of this section and section 6050Y, the term transfer of an interest in a life insurance contract means the transfer of any interest in the life insurance contract, including any transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract itself. The creation of an enforceable right to receive all or a part of the proceeds of a life insurance contract constitutes the transfer of an interest in the life insurance contract. The following events are not a transfer of an interest in a life insurance contract: The revocable designation of a beneficiary of the policy proceeds (until the designation becomes irrevocable other than by reason of the death of the insured); the pledging or assignment of a policy as collateral security; and the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035.

(3)Acquisition of an interest in a life insurance contract. For purposes of this section and section 6050Y, the acquisition of an interest in a life insurance contract may be direct or indirect.

(i) Direct acquisition of an interest in a life insurance contract. For purposes of this section and section 6050Y, the transfer of an interest in a life insurance contract results in the direct acquisition of the interest by the transferee (acquirer).

(ii) Indirect acquisition of an interest in a life insurance contract. For purposes of this section and section 6050Y, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest (whether legal or beneficial) in the life insurance contract. For purposes of this paragraph (e)(3)(ii), the term other entity does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts (as determined under paragraph (f)(4) of this section) immediately before the indirect acquisition.

(f)Definitions. The following definitions apply for purposes of this section:

(1)Beneficial owner. A beneficial owner of a partnership, trust, or other entity is an individual or C corporation with an ownership interest in that entity. The interest may be held directly or indirectly, through one or more other partnerships, trusts, or other entities. For instance, an individual that directly owns an interest in a partnership (P1),

which directly owns an interest in another partnership (P2), is an indirect beneficial owner of P2 and any assets or other entities owned by P2 directly or indirectly. For purposes of this paragraph (f)(1), the beneficial owners of a trust include those who may receive current distributions of trust income or corpus and those who could receive distributions if the trust were to terminate currently.

(2)C corporation. The term C corporation has the meaning given to it in section 1361(a)(2).

(3)Family member. With respect to any individual, the term family member refers to any person described in paragraphs (f)(3)(i) through (vi) of this section. For purposes of this paragraph (f)(3), full effect is given to a legal adoption, and a step-child is deemed to be a descendant. The family members of an individual include:

(i) The individual;

(ii) The individual's spouse or a person with whom the individual is in a registered domestic partnership, civil union, or other similar relationship established under state law;

(iii) Any parent, grandparent, or great-grandparent of the individual or of the person described in paragraph (f)(3)(ii) of this section and any spouse of such parent, grandparent, or great-grandparent, or person with whom the parent, grandparent, or great-grandparent is in a registered domestic partnership, civil union, or other similar relationship established under state law;

(iv) Any lineal descendant of the individual or of any person described in paragraph (f)(3)(ii) or (iii) of this section;

(v) Any spouse of a lineal descendant described in paragraph (f)(3)(iv) of this section and any person with whom such a lineal descendant is in a registered domestic partnership, civil union, or other similar relationship established under state law; and

(vi) Any lineal descendant of a person described in paragraph (f)(3)(v) of this section.

(4)Gross value of assets.

(i) Determination of gross value of assets. Except as provided in paragraph (f)(4)(ii) or (iii) of this section, for purposes of paragraphs (c)(2)(iii)(B) and (e)(3)(ii) of this section, the term gross value of assets means, with respect to any entity, the fair market value of the entity's assets, including assets beneficially owned by the entity under paragraph (f)(1) of this section as a beneficial owner of a partnership, trust, or other entity.

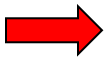
(ii) Determination of gross value of assets of publicly traded entity. For purposes of determining the gross value of assets of an entity that is publicly traded, if the entity's annual Form 10-K filed with the United States Securities and Exchange Commission (or equivalent annual filing if the entity is publicly traded in a non-U.S. jurisdiction) for the period immediately preceding a person's acquisition of

an ownership interest in the entity does not contain information demonstrating that more than 50 percent of the gross value of the entity's assets consists of life insurance contracts, that person may assume that no more than 50 percent of the gross value of the entity's assets consists of life insurance contracts, unless that person has actual knowledge or reason to know that more than 50 percent of the gross value of the entity's assets consists of life insurance contracts.

(iii) Safe harbor definition of gross value of assets. An entity may choose to determine the gross value of all the entity's assets for purposes of this section using the following alternative definition of gross value of assets:

(A) In the case of assets that are life insurance policies or annuity or endowment contracts that have cash values, the cash surrender value as defined in section 7702(f)(2)(A); and

(B) In the case of assets not described in paragraph (f)(4)(iii)(A) of this section, the adjusted bases (within the meaning of section 1016) of such assets.



(5) Transfer for valuable consideration. A transfer for valuable consideration means any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value.

(g) Examples. The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value:

(1)

Example (1). A is the initial policyholder of a \$100,000 insurance policy on A's life. A sells the policy to B, A's child, for \$6,000, its fair market value. B is not a partner in a partnership in which A is a partner. B receives the proceeds of \$100,000 upon the death of A. Because the transfer to B was for valuable consideration, and none of the exceptions in paragraph (b)(1)(ii) of this section applies, the amount of the proceeds B may exclude from B's gross income under this section is limited under paragraph (b)(1)(i) of this section to \$6,000 plus any premiums and other amounts paid by B with respect to the policy subsequent to the transfer.

(2)

Example (2). The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B gratuitously transfers the policy back to A. A's estate receives the proceeds of \$100,000 on A's death. Because the transfer from B to A is a gratuitous transfer to the insured, and the preceding transfer from A to B was not a reportable policy sale, the amount of the proceeds A's estate may exclude from gross income under this section is not limited by paragraph (b)(2)(i) of this section.

(3)

Example (3). The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B sells the policy back to A for its fair market value. A's

estate receives the proceeds of \$100,000 on A's death. The transfer from A to B is not a reportable policy sale because the acquirer B has a substantial family relationship with the insured, A. The transfer from B to A also is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A. Accordingly, paragraph (b)(1)(ii)(B)(1) of this section applies to the transfer to A, and the amount of the proceeds A's estate may exclude from gross income is not limited by paragraph (b) of this section.

(4)

Example (4). A is the initial policyholder of a \$100,000 insurance policy on A's life. A transfers the policy for \$6,000, its fair market value, to an individual, C, who does not have a substantial family, business, or financial relationship with A. The transfer from A to C is a reportable policy sale. C receives the proceeds of \$100,000 on A's death. The amount of the proceeds C may exclude from C's gross income under this section is limited under paragraph (b)(1)(i) of this section to \$6,000 plus any premiums and other amounts paid by C with respect to the policy subsequent to the transfer.

(5)

Example (5). The facts are the same as in Example 4 in paragraph (g)(4) of this section, except that before A's death, C transfers the policy to D, a partner of A who co-owns real property with A, for \$8,000, the policy's fair market value. D receives the proceeds of \$100,000 on A's death. The transfer from C to D is not a reportable policy sale because the acquirer D has a substantial financial relationship with the insured, A. However, because that transfer follows a reportable policy sale (the transfer from A to C), the amount of the proceeds that D may exclude from gross income under this section is limited by paragraph (b)(1)(ii)(B)(2) of this section to the sum of-

- (i) The higher of the amount C could have excluded had the transfer to D not occurred (\$6,000 plus any premiums and other amounts paid by C with respect to the policy subsequent to the transfer to C, as described in Example 4 in paragraph (g)(4) of this section) or the actual value of the consideration for that transfer paid by D (\$8,000); and
- (ii) Any premiums and other amounts paid by D with respect to the policy subsequent to the transfer to D.

(6)

Example (6). The facts are the same as in Example 4 in paragraph (g)(4) of this section, except that before A's death, C transfers the policy back to A for \$8,000, its fair market value. A's estate receives the proceeds of \$100,000 on A's death. The transfer from C to A is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A. Although the transfer follows a reportable policy sale (the initial transfer from A to C), A's estate may exclude all of the policy proceeds from gross income because paragraph (b)(1)(ii)(B)(3)(i) of this section applies and, therefore, the amount of the proceeds that A may exclude from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section.

(7)

Example (7). The facts are the same as in Example 6 in paragraph (g)(6) of this section, except that C transfers the policy back to A for \$4,000, rather than its fair market value of \$8,000. A's estate receives the proceeds of \$100,000 on A's death. Because A did not pay fair market value for the policy, the transfer is bifurcated and treated as a bargain sale

under paragraph (b)(2)(iii) of this section. A therefore is treated as having purchased 50% of the policy interest for valuable consideration equal to fair market value and as having received 50% of the policy interest in a gratuitous transfer. The transfer from C to A is not a reportable policy sale because the acquirer, A, has a substantial family relationship with the insured, A, but the transfer from C to A follows a reportable policy sale (the transfer from A to C).

(i) Treatment of policy interest purchased by A. A's estate may exclude from income all of the policy proceeds related to the 50% policy interest transferred for valuable consideration (\$50,000) because, under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds that may be excluded from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section.

(ii) Treatment of policy interest gratuitously transferred to A. The amount of the policy proceeds related to the 50% policy interest transferred gratuitously that A's estate may exclude from income is limited under paragraph (b)(2)(i) of this section to the sum of the amount C could have excluded with respect to 50% of the policy had the transfer back to A not occurred (that is, 50% of the \$6,000 that C paid A for the policy, plus 50% of any premiums and other amounts paid by C with respect to the policy subsequent to the transfer to C), plus 50% of any premiums and other amounts paid by A with respect to the policy subsequent to the transfer to A.

(8)

Example (8). The facts are the same as in Example 6 in paragraph (g)(6) of this section, except that, before A's death, A gratuitously transfers 50% of the policy interest to B, A's child, and sells 50% of the policy interest for its fair market value to an individual, E, who does not have a substantial family, business, or financial relationship with A. B and E each receive \$50,000 of the proceeds on A's death. Paragraph (b)(1)(ii)(B)(3)(ii) of this section applies to determine the amount of the proceeds that B and E may exclude from gross income because the policy interests transferred to B and E were first transferred for valuable consideration in a reportable policy sale (the transfer by A to C) and then transferred to the insured, A, for fair market value.

(i) Treatment of policy interest transferred to B. With respect to the portion of the policy interest transferred to B, because the transfer to B was the only transfer subsequent to the transfer to A and the transfer to B was gratuitous and not a reportable policy sale, under paragraph (b)(1)(ii)(B)(3)(ii) of this section, the amount of the policy proceeds excludable from gross income by B is determined under paragraph (b)(2)(i) of this section, taking into account the application of paragraph (b)(1)(ii)(B)(3)(i) of this section to A's acquisition of the interest. Under paragraph (b)(2)(i) of this section, the amount of the proceeds B may exclude is limited to the sum of the amount A could have excluded had the transfer to B not occurred, and any premiums and other amounts paid by B with respect to the policy subsequent to the transfer to B. As described in Example 6 in paragraph (g)(6) of this section, under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds that A may exclude from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section. Accordingly, the amount of the proceeds that B may exclude from gross income is not limited by paragraph (b) of this section.

(ii) Treatment of policy interest transferred to E. With respect to the portion of the policy interest transferred to E, because the transfer to E was not gratuitous and was a reportable policy sale, under paragraph (b)(1)(ii)(B)(3)(ii) of this section, the amount of the policy proceeds excludable from gross income by E is determined in accordance with paragraph

(b) of this section. Accordingly, because the transfer to E was for valuable consideration, the amount excludable from gross income by E is limited by paragraph (b)(1)(i) of this section unless an exception in paragraph (b)(1)(ii) of this section applies. Because the transfer from A to E is a reportable policy sale, none of the exceptions in paragraph (b)(1)(ii) of this section apply. Therefore, the amount of the proceeds E may exclude from gross income under this section is limited by paragraph (b)(1)(i) of this section to the sum of the consideration paid by E and the premiums and other amounts paid by E with respect to the policy subsequent to the transfer to E.

(9)

Example (9). The facts are the same as in Example 8 in paragraph (g)(8) of this section, except that, before A's death, B transfers B's policy interest to Partnership F, whose partners are A and other family members of A, in exchange for a partnership interest in Partnership F. Partnership F receives \$50,000 of the proceeds on A's death. With respect to the policy interest transferred to Partnership F, paragraph (b)(1)(ii)(B)(3)(ii) of this section applies to determine the amount of the proceeds that Partnership F may exclude from gross income for the reasons described in Example 8 in paragraph (g)(8) of this section.

(i) Treatment of policy interest transferred to Partnership F. The transfer to Partnership F was not a reportable policy sale. However, because the transfer to Partnership F was not gratuitous, the amount of the policy proceeds excludable from gross income by Partnership F is determined in accordance with paragraph (b) of this section as if the amount that would have been excludable from gross income by A following the transfer to A, if no subsequent transfer had occurred, was determined under paragraph (b)(1)(ii)(B)(2) of this section. Because B's transfer to Partnership F was a transfer for valuable consideration to a partnership in which the insured is a partner that was preceded by a reportable policy sale (the transfer to C), the amount of the proceeds Partnership F may exclude from gross income under this section is limited under paragraph (b)(1)(ii)(B)(2) of this section to the higher of the amount that would have been excludable by B if the transfer to Partnership F had not occurred or the actual value of the consideration for the policy paid by Partnership F, plus any premiums and other amounts paid by Partnership F with respect to the policy subsequent to the transfer to Partnership F.

(ii) Amount that B could have excluded. Because the transfer from A to B was a gratuitous transfer, the amount of the proceeds B could have excluded from gross income under this section if the transfer to Partnership F had not occurred is limited under paragraph (b)(2)(i) of this section to the sum of the amount A could have excluded had the transfer to B not occurred, and any premiums and other amounts paid by B with respect to the policy subsequent to the transfer to B.

(iii) Amount that A could have excluded. As described in paragraph (g)(9)(i) of this section, the amount of the proceeds A could have excluded under this section if the transfer to B had not occurred must be determined under paragraph (b)(1)(ii)(B)(2) of this section in accordance with paragraph (b)(1)(ii)(B)(3)(ii) of this section. Under paragraph (b)(1)(ii)(B)(2) of this section, the amount that would have been excludable by A is limited to the higher of the amount that would have been excludable by C if the transfer to A had not occurred (\$6,000 plus premiums and other amounts subsequently paid by C) or the actual value of the consideration for the policy paid by A (\$8,000), plus any premiums and other amounts paid by A with respect to the policy subsequent to the transfer to A.

(10)

Example (10). A is the initial policyholder of a \$100,000 insurance policy on A's life. A contributes the policy to Corporation X in exchange for stock. Corporation X's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. Corporation X conducts an active trade or business that it wholly owns, and A materially participates in that active trade or business as an employee of Corporation X. Corporation X receives the proceeds of \$100,000 on A's death. A's contribution of the policy to Corporation X is not a reportable policy sale because Corporation X has a substantial business relationship with A under paragraph (d)(2)(i) of this section. Although Corporation X's basis in the policy is determinable in whole or in part by reference to A's basis in the policy, paragraph (b)(1)(ii)(A) of this section does not apply because the insured, A, is a shareholder of Corporation X and the other requirements under paragraph (b)(1)(ii)(B) of this section are satisfied. Accordingly, paragraph (b)(1)(ii)(B) of this section applies, and paragraph (b)(1)(ii)(A) of this section is inapplicable. Under paragraph (b)(1)(ii)(B)(1) of this section, Corporation X's exclusion is not limited by paragraph (b) of this section.

(11)

Example (11). The facts are the same as in Example 10 in paragraph (g)(10) of this section, except that Corporation X transfers its active trade or business and the policy on A's life to Corporation Y in a tax-free reorganization at a time when A is still employed by Corporation X, but is no longer a shareholder of Corporation X. Corporation Y's basis in the policy is determinable in whole or in part by reference to Corporation X's basis in the policy, and Corporation Y carries on the trade or business acquired from Corporation X. Corporation Y receives the proceeds of \$100,000 on A's death. The transfer from Corporation X to Corporation Y is not a reportable policy sale because Corporation Y has a substantial business relationship with A under paragraph (d)(2)(ii) of this section. The amount of the proceeds that Corporation Y may exclude from gross income is limited under paragraph (b)(1)(ii)(A) of this section to the sum of the amount that would have been excludable by Corporation X had the transfer to Corporation Y not occurred, plus any premiums and other amounts paid by Corporation Y with respect to the policy subsequent to the transfer. Accordingly, because Corporation X's exclusion is not limited by paragraph (b) of this section, as described in Example 10 in paragraph (g)(10) of this section, Corporation Y's exclusion is not limited by paragraph (b) of this section.

(12)

Example (12). A is the initial policyholder of a \$100,000 insurance policy on A's life. A contributes the policy to a C corporation, Corporation W, in exchange for stock. After the acquisition, A owns less than 20% of the outstanding stock of Corporation W and owns stock possessing less than 20% of the total combined voting power of all stock of Corporation W and is therefore not a key person with respect to Corporation W under section 264(e)(3). Corporation W's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. However, no substantial family, business, or financial relationship exists between A and Corporation W, so A's contribution of the policy to Corporation W is a reportable policy sale. Corporation W receives the proceeds of \$100,000 on A's death. Under paragraph (b)(1)(i) of this section, the amount of the proceeds Corporation W may exclude from gross income is limited to the actual value of the stock exchanged for the policy, plus any premiums and other amounts paid by

Corporation W with respect to the policy subsequent to the transfer. The exceptions in paragraph (b)(1)(ii) of this section do not apply because the transfer to Corporation W is a reportable policy sale.

(13)

Example (13). Partnership X and Partnership Y are owned by individuals A, B, and C. A holds 40% of the capital and profits interest of Partnership X and 20% of the capital and profits interest of Partnership Y. B holds 35% of the capital and profits interest of Partnership X and 40% of the capital and profits interest of Partnership Y. C holds 25% of the capital and profits interest of Partnership X and 40% of the capital and profits interest of Partnership Y. Partnership X is the initial policyholder of a \$100,000 insurance policy on the life of A. Partnership Y purchases the policy from Partnership X. Under paragraph (c)(2)(i) of this section, this transfer is not a reportable policy sale because the ownership interest of each beneficial owner in Partnership X does not vary from that owner's interest in Partnership Y by more than a 20% ownership interest. A's ownership varies by a 20% interest, B's ownership varies by a 5% interest, and C's ownership varies by a 15% interest.

(14)

Example (14). Partnership X conducts an active trade or business and is the initial policyholder of a \$100,000 insurance policy on the life of its full-time employee, A. A materially participates in Partnership X's active trade or business in A's capacity as an employee. Individual B acquires a 10% profits interest in Partnership X in exchange for a cash payment of \$1,000,000. Under paragraphs (d)(1) through (3) of this section, B does not have a substantial family, business, or financial relationship with A. Under paragraph (d)(4)(i) of this section, however, B is deemed to have a substantial business relationship with A because, under paragraph (d)(2)(i) of this section, Partnership X (the direct policyholder) has a substantial business relationship with A. Accordingly, although the acquisition of the 10% partnership interest by B is an indirect acquisition of a 10% interest in the insurance policy covering A's life, the acquisition is not a reportable policy sale.

(15)

Example (15). The facts are the same as in Example 14 in paragraph (g)(14) of this section, except that A is no longer an employee of Partnership X, and Partnership X has no substantial family, business, or financial relationship with A, when B acquires the profits interest in Partnership X. Also, B acquires only a 5% profits interest in exchange for a cash payment of \$500,000. Partnership X does not own an interest in any other life insurance policies, and the gross value of its assets is \$10 million. Although neither Partnership X nor B has a substantial family, business, or financial relationship with A at the time of B's indirect acquisition of an interest in the policy covering A's life, because B's profits interest in Partnership X does not exceed 5%, and because no more than 50% of Partnership X's asset value consists of life insurance contracts, the exception in paragraph (c)(2)(iii)(B) of this section applies, and B's indirect acquisition of an interest in the policy covering A's life is not a reportable policy sale.

(16)

Example (16). A is the initial policyholder of a \$100,000 insurance policy on A's life. A sells the policy for its fair market value. As a result of the sale, Bank X holds legal title to

the life insurance contract as the nominee of Partnership B, and Partnership B has the enforceable right to designate the contract beneficiary. Under paragraphs (d)(1) through (4) of this section, neither Bank X nor Partnership B has a substantial family, business, or financial relationship with the insured, A, at the time of the sale. Accordingly, the transfer of legal title to the policy to Bank X is a reportable policy sale under paragraph (c)(1) of this section, unless an exception set forth in paragraph (c)(2) of this section applies. The same is true of the transfer of the economic benefits of the policy to Partnership B. At a later date, Partnership B sells its economic interest in the policy to Partnership C for fair market value. Bank X continues to hold legal title to the life insurance contract, but now holds it as Partnership C's nominee. Partnership C has no substantial family, business, or financial relationship with the insured, A, under paragraphs (d)(1) through (4) of this section at the time of the transfer. Accordingly, Partnership C's acquisition of the economic interest in the policy from Partnership B is a reportable policy sale under paragraph (c)(1) of this section, unless an exception set forth in paragraph (c)(2) of this section applies.