PART X: BUSINESS LIFE INSURANCE

8702. What is business life insurance?

As the name suggests, business life insurance is life insurance that is owned by a business, regardless of whether the business is organized as a sole proprietorship, partnership, or corporation. The insurance can serve a number of different purposes.

For example, business life insurance is often used to insure the life of a key employee, in order to mitigate the negative impact that the employee's death would have on the business. Business life insurance is also commonly used in the context of a buy-sell agreement, where the business is obligated to purchase the ownership interest of an owner who dies. The insurance also could be used to fund a non-qualified retirement package for a single employee or a number of employees.

8703. What is the income tax treatment to the insured of the premiums paid on business life insurance?

If the life insurance policy at issue is purchased for the benefit of the business and the insured has no ownership interest in the policy, the premiums generally are not taxable to the insured. Thus, premiums paid on key person life insurance, where an employer is both owner and beneficiary of the policy, are not taxable to the insured employee.[1]

If life insurance premiums are paid by an employer on a policy insuring the life of an employee and the proceeds are payable to the employee's beneficiary, there generally is some taxable income to the employee.

8704. What rules govern the deductibility of payment of the premiums on business life insurance?

Life insurance premiums generally are not deductible if the premium payer has any interest in the policy or proceeds.

Under IRC Section 264(a)(1), no deduction is allowed for premiums paid on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract. Where Section 264(a)(1) applies, the premiums are not deductible even though they otherwise would be deductible as ordinary and necessary business expenses.[2]

The rule under Section 264(a)(1) is an all or nothing rule, meaning that the entire premium will be nondeductible even though a premium payer has a right to receive only a portion of the proceeds. The deduction cannot be divided, and will either be allowed or disallowed in its entirety.[3] The rule under Section 264(a)(1) applies regardless of the form

1. *Casale v. Comm.*, 247 F.2d 440 (2d Cir. 1957); *Lacey v. Comm.*, 41 TC 329 (1963), *acq*. 1964-2 CB 6; Rev. Rul. 59-184, 1959-1 CB 65.
2. Treas. Reg. §1.264-1(a).
3. Rev. Rul. 66-203, 1966-2 CB 104.

of insurance, so it makes no difference whether premiums are paid on term, ordinary life, or endowment policies.

Section 264(a)(1) clearly prohibits the deduction for premiums paid where a taxpayer is the premium payer and is also designated as the policy beneficiary. For example, premiums paid on key person insurance, where an employer normally is both owner (and premium payer) and beneficiary of a policy, are nondeductible under IRC Section 264(a)(1).

The deduction is also denied under Section 264(a)(1) where a premium payer is only indirectly a beneficiary under a policy. Thus, the deduction will be denied where a taxpayer, even though not a named beneficiary, has some beneficial interest in a policy, such as the right to change the beneficiary, to make loans, to surrender the policy for cash, or to draw against proceeds held in trust for the insured's spouse.[1]

An employer is permitted to deduct premiums paid on insurance covering the life of an employee if the employer is not directly or indirectly a beneficiary under the policy and the premiums represent additional reasonable compensation for services rendered by the employee. Thus, if an employer has no ownership rights or beneficial interest in a policy and proceeds are payable to an employee's estate or personal beneficiary, the employer may ordinarily deduct the premiums as additional compensation paid to the employee.[2] The deduction will not be denied merely because an employer may derive some indirect benefit, such as from the increased efficiency of the employee.[3]

8705. Can a corporation deduct the premiums it pays on a life insurance policy insuring the life of an employee or stockholder?

Based on the IRC Section 264(a)(1) prohibition, a corporation is not permitted to deduct the premiums it pays on a policy insuring the lives of its employee or stockholder if it either is directly or indirectly a beneficiary under the policy. The deduction is denied even if the corporation has only a partial beneficial interest in a policy.[4]

A corporation cannot deduct premiums it pays on key person insurance or on a policy insuring the life of a stockholder purchased to fund the corporation's redemption of the insured's stock. Normally, in these instances, the corporation is both owner and beneficiary of a policy, so a deduction is not allowed by reason of IRC Section 264(a)(1). If the policy proceeds are to be used to pay for stock that is to be surrendered to the corporation, that corporation cannot deduct the premiums even though it may have no right to the cash value of a policy and no right to name or change the beneficiary. In this case, the deduction is not allowed because the premium payments are treated as capital expenditures, rather than ordinary and necessary business expenses, because they are payments for the acquisition of a corporate asset: treasury stock.[5]

1. Rev. Rul. 70-148, 1970-1 CB 60; Rev. Rul. 66-203, supra.
2. IRC Sec. 162(a); Treas. Reg. §1.162-7.
3. Treas. Reg. §1.264-1(b).
4. *National Indus. Investors, Inc. v. Comm.*, TC Memo 1996-151.
5. Rev. Rul. 70-117, 1970-1 CB 30; Rev. Rul. 74-503, 1974-2 CB 117.

Conversely, if a corporation purchases life insurance for an employee and the corporation has no ownership rights or beneficial interest in the policy, premiums are ordinarily deductible as additional compensation for the employee's services.[1]

To be deductible, however, the premium payments must represent *reasonable* compensation.[2] The question of whether compensation is reasonable often arises in the case of a stockholder-employee of a closely-held corporation. If the total amount paid to and on behalf of a stockholder-employee is found to represent an unreasonable return for services, the IRS may treat the premium payments as a distribution of profits or dividends rather than as compensation. This also may be the result where the corporation has kept insufficient records so that there is no evidence, such as board of directors' minutes, to show that premium payments were intended as compensation.[3]

If the surrounding circumstances are sufficient to show that the premiums were not paid as compensation, the deduction will be disallowed. In *Atlas Heating & Ventilating Co. v. Comm.*,[4] for example, evidence showed that premiums actually were paid to fund a stock purchase agreement between individual stockholders. Consequently, the premiums were not compensation, but dividends. The policies were owned by the stockholder-employees and proceeds were payable to their personal beneficiaries. The insured individuals had agreed that, on each of their deaths, an amount of stock equal to the proceeds received by the deceased insured's beneficiaries would be turned in to the corporation and then distributed pro rata to the surviving stockholders.

For a discussion of the treatment of premiums paid by an S corporation on behalf of its shareholders or employees, see Q 8710.

8706. When a corporation owns a life insurance policy insuring the life of a key employee, are the premiums paid by the corporation taxable to the key employee?

No.[5] In *Casale v. Comm.*, the insured was president of the corporation and owned 98 percent of its stock. The corporation was both owner and beneficiary of a retirement income contract on the insured's life, which the corporation had purchased to hedge its obligation to the insured under a deferred compensation agreement. The Tax Court required the insured to include premiums paid by the corporation in his income. The Second Circuit reversed the Tax Court opinion, however, on the grounds that the corporation's separate entity could not be ignored and that the insured had received no current economic benefit that would constitute taxable income.

However, see *Goldsmith v. U.S.*, where the taxpayer, an independent contractor, was required to include the death and disability insurance features of a deferred compensation agreement in his income based on the court's finding that (a) those features conferred a current economic

1. IRC Sec. 162(a).
2. Treas. Reg. §1.162-7.
3. *Boecking v. Comm.*, TC Memo 1993-497; *Est. of Worster v. Comm.*, TC Memo 1984-123; *Champion Trophy Mfg. Corp. v. Comm.*, TC Memo 1972-250.
4. 18 BTA 389 (1929).
5. *Casale v. Comm.*, 247 F.2d 440 (2d Cir. 1957); Rev. Rul. 59-184, 1959-1 CB 65.

benefit on the taxpayer and (b) the current economic benefit of the insurance components were capable of valuation.[1]

The IRS, however, has agreed to follow the Second Circuit's decision as precedent in dealing with similar cases.[2]

8707. Are premiums paid by a corporation on life insurance to fund a stock redemption agreement taxable to an insured stockholder?

No. Even if the stockholder has the right to designate the policy beneficiary, the premiums are not income to the stockholder, provided that the beneficiary's right to receive the proceeds is conditioned on the transfer of stock to the corporation.[3]

Similarly, premiums are not taxable income to an insured stockholder when a trustee is named beneficiary, provided that the trustee is obligated to use the proceeds to purchase the insured's stock for transfer to the corporation.[4]

8708. Are life insurance premiums paid by an employer taxable income to an insured employee if the proceeds are payable to the employee's estate or personal beneficiary and the policy is owned by the employee?

Yes.[5] However, if dividends are applied to reduce current premiums, only the net premium must be included in the employee's taxable income.[6]

The premium payments are generally treated as additional compensation paid to the employee and are, therefore, deductible by the employer. However, if the employer is a closely-held corporation and the employee a stockholder, the IRS may challenge the arrangement on the grounds that the premiums are disguised dividends taxable to the insured, but not deductible by the corporation (See Q 8704).

Even where an insured employee and owner of the corporation was not the owner of the policy, but the employee's son or spouse was owner and beneficiary, payment of premiums on the policy was found to confer an economic benefit to the employee and, as such, was includable in the employee's gross income.[7]

Where a stockholder-employee argued that premiums paid by the corporation on the employee's personal insurance were merely loans, the premiums were treated as taxable dividends. This will be the result unless the employee can produce evidence to show that the employee intended to reimburse the corporation for the premium payments.[8]

1. 41 AFTR 2d 978 (Ct. Cl. 1978).
2. Rev. Rul. 59-184, supra. See also: *U.S. v. Leuschner*, 11 AFTR 2d 782 (S.D. Cal. 1962); *Lacey v. Comm.*, 41 TC 329 (1963), *acq.*, 1964-2 CB 6.
3. *Sanders v. Fox*, 253 F.2d 855 (10th Cir. 1958); *Prunier v. Comm.*, 248 F.2d 818 (1st Cir. 1957); Rev. Rul. 59-184, 1959-1 CB 65.
4. Rev. Rul. 70-117, 1970-1 CB 30.
5. Treas. Reg. §1.61-2(d)(2)(ii)(A); *Canaday v. Guitteau*, 86 F.2d 303 (6th Cir. 1936); *Yuengling v. Comm.*, 69 F.2d 971 (3rd Cir. 1934).
6. *Weeks v. Comm.*, 16 TC 248 (1951); *Sturgis v. Comm.*, TC Memo 1951, 10 TCM (CCH) 136.
7. *Brock v. Comm.*, TC Memo 1982-335; *Champion Trophy Mfg. Corp. v. Comm.*, TC Memo 1972-250; see IRC Sec. 301(c).
8. *Schwartz v. Comm.*, TC Memo 1963-340; *Jameson v. Comm.*, TC Memo 1942.

8709. Are life insurance premiums paid by an employer taxable income to an insured employee if the proceeds are payable to the employee's estate or personal beneficiary and the corporation owns the policy?

The tax results of an arrangement whereby an employer pays the premiums on a policy insuring the life of an employee are uncertain when the corporation owns the policy, unless the insured is a stockholder and the insurance is to be used to fund an agreement for the purchase of the insured's stock. The regulations provide: "Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee."[1] This suggests that the entire premium is taxable to the employee.

However, the final regulations associated with the taxation of split dollar life insurance arrangements indicate that where an employer pays all or any portion of the premiums on a life insurance contract insuring the employee and the beneficiary of all or a portion of the death benefit is designated by the employee or is any person whom the employee would reasonably be expected to designate as the beneficiary, the employee must include the amount of the "economic benefit" associated with the life insurance coverage provided in the employee's income.[2] This economic benefit generally will be the cost of current life insurance provided to the employee as calculated using Table 2001 rates or using a carrier's alternative term rates.[3] The split dollar regulations are effective for split dollar arrangements entered into (or contracts that are materially modified) after September 17, 2003.[4]

8710. How are life insurance policy premiums paid by an S corporation to insure a shareholder or employee taxed?

An S corporation generally does not pay taxes at the entity level. Instead, items of income, deduction, loss, and credit are passed through to shareholders and taxes are calculated at the individual level. Payment of premiums by an S corporation should be characterized as a nondeductible expense, as deductible compensation, or as a nondeductible distribution of profits under the same general rules applicable to regular (C) corporations. However, the resulting tax treatment of the shareholders would differ in some instances.

If the premium payment is treated as a nondeductible expense, as it would be if a corporation were both owner and beneficiary of a key person policy, shareholders will be required to reduce the basis in their shares by their proportionate portion of the nondeductible expense.[5]

If particular premium payments are treated as employee compensation, such as in a case where an employee owns a policy or has a beneficial interest in it, the amount of compensation would be deductible in determining the S corporation's income or loss that is reported pro

1. Treas. Reg. §1.61-2(d)(2)(ii)(A).
2. Treas. Regs. §§1.61-22(b)(2)(ii); 1.61-22(d).
3. Treas. Reg. §1.61-22(d)(2)(i); Notice 2002-8, 2002-1 CB 398.
4. Treas. Reg. §1.61-22(j).
5. IRC Sec. 1367(a)(2)(D).

rata by each shareholder. The amount of compensation then must be included in income by the insured employee.[1]

When a premium payment is found to be a distribution with respect to stock to an individual shareholder, the tax treatment depends on whether the corporation has accumulated earnings and profits. If a corporation has no accumulated earnings and profits, the payment is treated first as a return of investment and then as capital gain. If a corporation has accumulated earnings and profits, part of the distribution might be treated as a dividend.[2] For example, an S corporation may have accumulated earnings and profits from years when it was a C corporation or as the result of a corporate acquisition.

The IRS has provided guidance on the effects of premiums paid by an S corporation on an employer-owned life insurance (EOLI) contract (See Q 8716) and the benefits received by reason of death of the insured on its accumulated adjustments account (AAA) under IRC Section 1368. The IRS ruled that premiums paid by an S corporation on an EOLI contract when the S corporation is directly or indirectly a beneficiary do not reduce the S corporation's AAA. Further, it ruled that benefits received by reason of the death of the insured from an EOLI contract that meets an exception under IRC Section 101(j)(2) do not increase the S corporation's AAA.[3]

8711. Are life insurance policy premiums deductible if paid by a partnership or an individual partner on the life of a copartner?

No. This is true regardless of who is named as policy beneficiary. Premiums paid for any life insurance, or endowment or annuity contract, are not deductible if a taxpayer is directly or indirectly a beneficiary under the policy or contract.[4] The premium paying partner will derive a benefit from the policy even if the insurance is purchased as a key person policy or to finance the purchase of an insured's partnership interest.[5]

The general rules governing the deductibility of life insurance premiums (see Q 8704) apply in the case of insurance purchased by a partnership on the life of an employee who is not a partner.

8712. Are life insurance premiums paid by a partner for insurance on the partner's own life deductible by the partner if the proceeds are payable to a partnership or to a copartner?

No, because of the general rule that premiums paid on any life insurance policy, or endowment or annuity contract, are not deductible if a taxpayer is directly or indirectly a beneficiary under the policy or contract.[6] When a policy is purchased as key person insurance or to finance the purchase of an insured's partnership interest, the insured's estate and, therefore, the insured, will benefit from the policy.

1. IRC Secs. 1363, 1366.
2. IRC Sec. 1368.
3. Rev. Rul. 2008-42, 2008-30 IRB 175.
4. IRC Sec. 264(a)(1).
5. Treas. Reg. §1.264-1.
6. IRC Sec. 264(a)(1).

Even if a partner takes out insurance on the partner's own life and irrevocably designates a copartner as beneficiary to induce the copartner to leave the copartner's investment in the firm, the insured partner is *indirectly* a beneficiary under the policy, and so the premiums cannot be deducted.[1]

8713. Can a sole proprietor deduct life insurance premiums paid for insurance on the sole proprietor's own life?

No. This is true regardless of who is beneficiary under the policy. In the case of a sole proprietorship, premium payments are treated as nondeductible personal expenses because a sole proprietor and the business are considered one and the same for tax purposes.[2]

The general rules governing the deductibility of life insurance premiums (see Q 8704) apply in the case of insurance purchased by a sole proprietor on the life of an employee.

8714. Can an employee of a sole proprietor deduct life insurance premiums the sole proprietor pays to insure the life of the sole proprietor?

No. The premiums are nondeductible because they either are personal expenses or expenses allocable to tax-exempt income (the death proceeds).[3]

8715. Are death proceeds of business life insurance exempt from income tax? Could receipt of tax-exempt income from insurance proceeds reduce an otherwise tax-deductible capital loss?

The general rules applicable to life insurance contracts also apply in the case of business life insurance. As such, the entire lump sum payable at an insured's death is exempt from regularly calculated income tax regardless of whether the beneficiary is an individual, a corporation, a partnership, a trust, or the insured's estate.[4]

See Q 8716 for rules pertaining to employer-owned life insurance contracts issued after August 17, 2006.

A portion of the death proceeds may be taxable if the proceeds are paid out under a life income or other installment option. In this case, the amount payable at death may be prorated and recovered from the payments in equal tax-free amounts over the payment period, but the interest earned on the proceeds over the distribution period is taxable.

Proceeds received by a partnership or by an S corporation retain their tax-exempt character when passed on to individual partners or shareholders. Proceeds received tax-free by a regular (C) corporation are, when paid out, usually taxable to the recipients as compensation or dividends.

Despite the general rule, there are some circumstances where death proceeds paid out in a lump sum are not wholly tax-exempt. For example, the IRC expressly provides that proceeds

1. Treas. Reg. §1.264-1.
2. IRC Sec. 262(a); Treas. Reg. §1.262-1(b)(1).
3. IRC Secs. 262(a), 265(a)(1); see *Whitaker v. Comm.*, 34 TC 106 (1960).
4. IRC Sec. 101(a); Treas. Reg. §1.101-1(a).

are taxable, under some circumstances, where a policy has previously been sold or otherwise transferred for a valuable consideration (see Q 8717 to Q 8720).

Under Section 101(a), in the case of proceeds payable under qualified pension or profit sharing plans, only the amount in excess of the cash surrender value is tax-exempt. The same rule applies to proceeds received under a tax sheltered annuity and proceeds received under individual retirement endowment contracts.

In some cases, the exemption may not be available because proceeds are not considered to be received as life insurance proceeds. These include proceeds that are taxable as dividends or compensation, proceeds that are taxable because of lack of insurable interest, proceeds taxable as a return of embezzled funds, and proceeds of creditor insurance.

Where liquidation of a business after a partner's death resulted in a loss, but life insurance on that partner had been purchased by the other partner for the purpose of protecting his capital investment in the business, the court ruled that because the loss was compensated for by insurance, it was not deductible. IRC Section 165(a) provides that "[t]here shall be allowed as a deduction any loss sustained during the taxable year *and not compensated for by insurance or otherwise*" (emphasis added).[1]

8716. For employer-owned life insurance contracts issued after August 17, 2006, are there any special requirements that must be met in order for the proceeds to be exempt from income tax?

An employer-owned life insurance contract is defined as a life insurance contract owned by a person or entity engaged in a trade or business under which that person or entity, or certain related persons, is a beneficiary under the contract, if the contract covers the life of an insured who is an employee when the contract is issued.[2] For life insurance contracts entered into after August 17, 2006, certain requirements must be met for death proceeds of an employer-owned life insurance contract to be received income-tax free.

First, before an employer-owned life insurance contract is issued, the employer must meet the following notice and consent requirements:

(1) The employer must notify the insured employee in writing that the employer intends to insure the employee's life;

(2) The employer must provide notice of the maximum face amount the employee's life could be insured for at the time the contract is issued;

(3) The employer must state that the policy owner will be the beneficiary of the death proceeds of the policy; and

(4) The insured also must give written consent to be the insured under the contract and consent to coverage continuing after the insured terminates employment.[3]

1. *Johnson v. Comm.*, 66 TC 897 (1976), *aff'd*, 78-1 USTC ¶9367 (4th Cir. 1978).
2. IRC Sec. 101(j)(3)(A).
3. IRC Sec. 101(j)(4).

Another set of requirements relates to an insured's status with an employer. The insured must have been (i) an employee at any time during the twelve month period before his or her death, or (ii) a director or highly compensated employee at the time the contract was issued. A "highly compensated employee" is one who is classified as highly compensated under the qualified plan rules of IRC Section 414(q) (except for the election regarding the top paid group), or under rules regarding self-insured medical expense reimbursement plans of IRC Section 105(h), except that the highest paid 35 percent instead of 25 percent will be considered highly compensated.[1]

In the alternative, death proceeds of employer-owned life insurance will not be included in an employer's income, assuming the notice and consent requirements are met, if the proceeds are paid to any of the following:

(1) A member of an insured's family, defined as a sibling, spouse, ancestor, or lineal descendent;

(2) Any individual who is the designated beneficiary of the insured under the contract (other than the policy owner);

(3) A trust that benefits a member of the family or designated beneficiary; or

(4) The estate of the insured.

Additionally, the proceeds will not be included in an employer's income if death proceeds are used to purchase an equity interest from a family member, beneficiary, trust, or estate.[2] The Pension Protection Act of 2006 ("PPA 2006") also imposes new reporting requirements on all employers owning one or more employer-owned life insurance contracts. Final reporting regulations were issued in November 2008.[3]

Further, the IRS released Notice 2009-48, which provides guidance on certain issues that may arise when dealing with employer-owned life insurance contracts with respect to IRC Section 101(j)'s notice and consent requirements and IRC Section 6039I's information reporting requirements. The guidance, which is presented in a question-and-answer format, is effective June 15, 2009, but the IRS has announced that it will not challenge a taxpayer who made a good faith effort to comply with IRC Section 101(j) based on a reasonable "interpretation of the provision before that date."

Reporting Requirements

All employers who own one or more life insurance contracts on the life of any employee that are considered employer-owned contracts under IRC 101(j) must file with the IRS an informational return, which includes the following information:

(1) The number of employees of the "applicable policy holder" (e.g. the employer) at the end of the year;

1. IRC Sec. 101(j)(2)(A).
2. IRC Sec. 101(j)(2)(B).
3. IRC Sec. 6039I; Treas. Reg. §1.6093I-1.

(2) The number of employees insured by employer-owned contracts at the end of the year;

(3) The total amount of insurance in force at the end of the year under such contracts,

(4) The name, address, and taxpayer ID number for the applicable policyholder and the type of business in which the policyholder is engaged; and

(5) That the applicable policyholder has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained).[1]

These reporting requirements became effective for tax years ending after November 6, 2008. To comply with the reporting requirements, the applicable policyholder must provide the requested information by attaching Form 8925 to the policyholder's income tax return by the due date of that return.[2]

8717. When will the sale of a life insurance policy cause the loss of the income tax exemption for death proceeds? What is the transfer for value rule?

Under IRC Section 101(a)(2), if a life insurance policy or any interest in a policy is transferred for a valuable consideration, the death proceeds generally will be exempt only to the extent of the consideration paid by the transferee and net premiums, if any, paid by the transferee after the transfer. Any interest paid or accrued by the transferee on indebtedness with respect to the policy is added to the exempt amount if the interest is not deductible under IRC Section 264(a)(4).[3] This provision regarding interest paid or accrued applies to contracts issued after June 8, 1997. Further, for purposes of this provision, any material increase in a death benefit or other material change in a contract shall be treated as a new contract with certain limited exceptions.[4]

After subtracting the permissible exclusions outlined above, the balance of the death proceeds is taxable as ordinary income. This is known as the "transfer for value rule." If a sale or other transfer for value comes within any of the following exceptions to the transfer for value rule, the exemption is available despite the sale or other transfer for value:

(1) The sale or other transfer for value is to the insured individual;[5]

(2) The sale or other transfer for value is 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 an officer or shareholder.[6] Members of a limited liability company ("LLC") taxed as a partnership are considered to be partners for this purpose;[7] or

1. IRC Sec. 6093I; Treas. Reg. §1.6093I-1.
2. Treas. Reg. §1.6093I-1.
3. IRC Sec. 101(a)(2).
4. TRA '97, Sec. 1084(d).
5. IRC Sec. 101(a)(2)(B).
6. IRC Sec. 101(a)(2)(B).
7. Let. Rul. 9625013.

(3) If the basis for determining gain or loss in the hands of the transferee is determined in whole or in part by reference to the basis of the transferor. This occurs, for example, where a policy is transferred from one corporation to another in a tax–free reorganization, where a policy is transferred between spouses, or where a policy is acquired in part by gift.[1]

See Q 8718 for a more thorough discussion of when a life insurance policy is considered to have been transferred for value. See Q 8719 for a more thorough discussion of the exceptions to the transfer for value rule.

8718. When is a life insurance policy transferred for value?

A "transfer for value" occurs upon any transfer for a valuable consideration of a right to receive all or part of the proceeds of a life insurance policy. As such, the transfer for value rule extends far beyond straightforward sales of policies. The naming of a beneficiary in exchange for any kind of valuable consideration would constitute a transfer for value of an interest in the policy. Even the creation by a separate contract of a right to receive all or part of the proceeds would constitute a transfer for value.[2]

On the other hand, a transfer for value does not occur upon a mere pledging or assignment of a policy as collateral security.[3]

A corporation's transfer of a policy to a stockholder as a distribution in liquidation is a transfer for value.[4] A transfer for value can occur even though the policy transferred has no cash surrender value.[5] Even if there is no actual purchase price that is paid for the policy or interest in the policy, a transfer will be considered a transfer for value, provided the transferor receives some other valuable consideration.[6]

In one case, two policies were purchased on the life of an officer-stockholder, one by the insured and the other by the corporation. Subsequently, the insured entered into an agreement with two employees for the purchase of his stock at his death. The policies were transferred to a trustee for use in partially financing the agreement and the employees took over the payment of premiums. Upon the insured's death, the proceeds were applied to the purchase of his stock. The court held that the employees were transferees for value even though they had paid no purchase price for the policies. Their agreement to make premium payments and to purchase the stock constituted a valuable consideration. As a result, the employees were taxed on the difference between the premiums they had paid and the proceeds applied toward their purchase of the insured's stock.[7]

1. IRC Sec. 101(a)(2)(A); Rev. Rul. 69-187, 1969-1 CB 45; Let. Rul. 8951056.
2. Treas. Reg. §1.101-1(b)(4).
3. Treas. Reg. §1.101-1(b)(4).
4. *Lambeth v. Comm.*, 38 BTA 351 (1938).
5. *James F. Waters, Inc. v. Comm.*, 160 F.2d 596 (9th Cir. 1947).
6. *Monroe v. Patterson*, 8 AFTR 2d 5142 (N.D. Ala. 1961).
7. *Monroe v. Patterson*, supra.

A transfer for value occurred where two shareholders assigned to each other existing policies that had no cash values on their own lives to fund a cross-purchase agreement.[1]

Similarly, where a partnership named two partners as cross-beneficiaries on policies owned by the partnership, a transfer for value was found.[2] In that case, however, an exception to the transfer for value rule was present (i.e. the partnership exception) to exclude insurance proceeds from gross income.

On the other hand, if a transferor receives no valuable consideration whatsoever, there is no transfer for value.[3]

Because a transfer of a policy subject to a nonrecourse loan discharges the transferor of his or her obligation under the loan, the transferor is treated as receiving an amount equal to the discharged obligation.[4] Thus, there may be a transfer for value when a life insurance contract that is subject to a policy loan is transferred. Nonetheless, where the value of a policy exceeded the outstanding loan, a transfer was ruled in part a gift and within one of the exceptions to the transfer for value rule because the basis of the policy in the hands of the transferee was, in part, determined by reference to the basis of the policy in the hands of the transferor.[5]

The IRS has ruled that the gratuitous transfer of a policy subject to a nonrecourse loan was partially a gift and partially a sale. Because the transferor's basis was greater than the amount of the loan, the basis of the policy in the hands of the transferee was the basis in the hands of the transferor at the time of transfer. As a result, the transfer fell within the same exception to the transfer for value rule.[6]

The transfer of a policy to a grantor trust treated as owned by the transferor was not a transfer for value where the insured individuals, terms, conditions, benefits, and beneficial interests other than naming the trustee as beneficiary and nominal owner did not change.[7]

The transfer of a life insurance policy from one grantor trust to another grantor trust, where both trusts were treated as owned by the same taxpayer, will not be treated as a transfer for value.[8]

The replacement of a jointly owned policy with two separately owned policies is also not a transfer for value.[9]

1. Let. Rul. 7734048.
2. Let. Rul. 9012063.
3. *Haverty Realty & Investment Co. v. Comm.*, 3 TC 161 (1944).
4. Treas. Reg. §1.1001-2(a).
5. Rev. Rul. 69-187, 1969-1 CB 45.
6. Let. Rul. 8951056. But see Let. Rul. 8628007.
7. Let. Rul. 9041052.
8. Rev. Rul. 2007-13, 2007-11 IRB 684.
9. Let. Rul. 9852041.

8719. What are the exceptions to the transfer for value rule that will permit a policy to be sold or otherwise transferred for value without the loss of the income tax exemption for death proceeds?

Several exceptions exist to allow proceeds of a life insurance contract to maintain their tax-exempt status even if there has been a transfer for value. If a sale or other transfer for value comes within any of the following exceptions to the transfer for value rule, the exemption from gross income is available despite the sale or other transfer for value:

(1) The sale or other transfer for value is to the insured individual;[1]

(2) The sale or other transfer for value is 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 an officer or shareholder.[2] Members of a limited liability company ("LLC") taxed as a partnership are considered to be partners for this purpose;[3] or

(3) If the basis for determining gain or loss in the hands of the transferee is determined in whole or in part by reference to the basis of the transferor. This occurs, for example, where a policy is transferred from one corporation to another in a tax–free reorganization, where a policy is transferred between spouses, or where a policy is acquired in part by gift.[4]

For example, if a corporation purchases a policy insuring a key person and later sells it to the insured, the proceeds will be received wholly tax-exempt by the beneficiary despite the sale to the insured.[5]

Moreover, a transfer to a trust that is treated as owned wholly or in part by the insured comes within the exception as a transfer to the insured to the extent the insured is treated as owner.[6] An individual is treated as owner of a trust where the individual retains control over property the individual has transferred to the trust so that the income on that property is taxable to the individual under IRC Sections 671-679.

Where a policy is transferred more than once but the last transfer, or the last transfer for value, is to the insured, 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 be wholly tax-exempt regardless of any previous sale or other transfer for value.[7] If the insured transfers the policy for a valuable consideration, and the transfer does not come within any of the exceptions to the transfer for value rule, the proceeds again will lose their tax-exempt status.

1. IRC Sec. 101(a)(2)(B).
2. IRC Sec. 101(a)(2)(B).
3. Let. Rul. 9625013.
4. IRC Secs. 101(a)(2)(A); 1041; Rev. Rul. 69-187, 1969-1 CB 45; Let. Rul. 8951056.
5. See Let. Rul. 8906034.
6. Rev. Rul. 2007-13; *Swanson v. Comm.*, 75-2 USTC ¶9528 (8th Cir. 1975).
7. Treas. Reg. §1.101-1(b)(3)(ii).

Example: X Corporation purchases an insurance policy for a single premium of $500 with a face amount of $1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. The X Corporation transfers the policy to the Y Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Y Corporation determined by reference to its basis in the hands of the X Corporation). The Y Corporation later transfers the policy to the Z Corporation for $600. The Z Corporation receives the proceeds of $1,000 upon the death of A. The amount which the Z Corporation can exclude from its gross income is limited to $600 plus any premiums paid by the Z Corporation subsequent to the transfer of the policy to it.

If Z Corporation, however, before A's death, transfers the policy to the N Corporation, in which A is a shareholder, the N Corporation would receive the $1,000 proceeds upon A's death free from income taxes.[1]

8720. If an employer (or the employer's qualified plan) sells or distributes a policy that insures an employee's life to the insured's spouse or other family member, will the transfer cause the loss of the income tax exemption for death proceeds?

Yes, generally, unless the transferee is a partner of the insured. The exceptions to the transfer for value rule will not exempt this type of transaction from the general rule. Therefore, if a sale is involved, the death proceeds will be taxable to the extent that they exceed the consideration paid by the purchaser plus net premiums, if any, paid after the sale. Any interest paid or accrued by the transferee on policy indebtedness may be added to the exempt amount under certain circumstances.

Even if a spouse or family member pays nothing for a policy, a transfer may be considered a transfer for value based on the idea that the employee's past or promised future services constituted a valuable consideration for the transfer. The proceeds then probably would be taxable to the extent that they exceed the value of the contract at the time of transfer plus any subsequent premium payments and certain policy indebtedness.

The transfer for value rule would not cause taxation of the proceeds of a policy that is (i) transferred to an insured, followed by a gift from the insured to the insured's spouse or family member, or (ii) a sale to the insured's spouse after July 18, 1984.[2] A federal appeals court refused to treat a direct transfer by an employer to the wife of an insured employee for a consideration as two transfers merged into one: a transfer to the insured employee and then a gift from him to his wife.[3]

8721. What is a Section 79 plan?

IRC Section 79 allows an employer to provide up to $50,000 of tax-free group-term life insurance coverage to each of its employees.[4] More specifically, the employee may exclude the value of the group-term life insurance that does not exceed the sum of (a) $50,000 and (b) any amount paid by the employee toward the purchase of the insurance.[5]

1. Treas. Reg. §1.101-1(b)(5), Examples (3) and (5).
2. IRC Sec. 1041.
3. *Est. of Rath v. U.S.*, 79-2 USTC ¶9654 (6th Cir. 1979).
4. IRC Sec. 79(a)(1).
5. IRC Sec. 79(a).

Group-term life insurance that is excludable under Section 79 can also be offered through a cafeteria plan (see Q 8787).[1]

See Q 8722 for a discussion of how it is determined whether the value of the insurance exceeds the $50,000 limit and Q 8723 for a discussion of situations in which the $50,000 limit may not apply. See Q 8724 for the nondiscrimination requirements applicable to Section 79 plans.

8722. How is it determined whether the cost of group-term life insurance provided under a Section 79 plan exceeds the $50,000 excludable limit?

The cost of up to $50,000 of group-term life insurance coverage generally is tax-exempt under IRC Section 79 (see Q 8721). The cost of coverage in excess of $50,000 is taxable to the employee in most situations (see Q 8723 for a discussion of the exceptions).

In calculating the cost of coverage, an employee who has more than one employer must combine all group-term coverage and is entitled to exclude only $50,000 of the combined coverage. If an employee contributes toward the cost of the insurance, all of the employee's contribution for coverage will be subtracted from the amount that would otherwise be taxable.[2] The employee cannot carry over any unused portion of his or her contributions from year to year.

The taxable cost of coverage in excess of $50,000, must be calculated on a monthly basis. The steps are as follows:

(1) Determine the total amount of group-term life insurance coverage for the employee in each calendar month of the employee's taxable year, and if a change occurs during any month, take the average at the beginning and end of the month;

(2) subtract $50,000 from each month's coverage;

(3) apply the appropriate rate from the applicable tables of monthly premium rates (reproduced below) to the balance, if any, for each month;

(4) subtract total employee contributions for the year, if any, from the sum of the monthly costs.[3]

The cost is determined on the basis of the life insurance protection provided to an employee during the employee's tax year, without regard to when the premiums are paid by an employer. The rates in the table provided immediately below should be used to compute the cost of excess group-term life insurance coverage.[4]

1. Prop. Treas. Reg. §1.125-1(k).
2. IRC Sec. 79.
3. Treas. Reg. §1.79-3.
4. Treas. Reg. §1.79-3(d)(2).

*Uniform Premiums for $1,000 of Group-Term Life Insurance Protection**
Rates Applicable to Cost of Group-Term Life Insurance Provided After June 30, 1999

5-Year Age Bracket	Cost per $1,000 of Protection for One-Month Period
Under 25	$0.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	1.27
70 and above	2.06

*In using the above table, the age of the employee is the employee's attained age on the last day of the employee's taxable year.

8723. Are there any exceptions to the general rule that an employee may only exclude the first $50,000 of group-term life insurance provided under a Section 79 plan?

Yes. There are certain exceptions to the $50,000 ceiling on tax-exempt coverage. The cost of group-term life insurance, even for amounts over $50,000, is tax-exempt in the following situations:

(1) the insurance is provided to a former employee who:

(a) has terminated his or her employment as an employee with the employer and has become permanently disabled,

(b) has terminated his or her employment on or before January 1, 1984, and was covered by the plan or by a predecessor plan when he or she retired if the plan was in existence on January 1, 1984, or the plan is a comparable successor to such a plan, or

(c) has terminated employment as an employee after January 1, 1984, having attained age fifty-five on or before January 1, 1984, and having been employed by the employer at any time during 1983 if the plan was in existence on January 1, 1984, or the plan is a comparable successor to such a plan, *unless* the individual retired under the plan after 1986 and the plan is discriminatory after that date, not taking into account insurance provided to employees who retired before January 1, 1987;

(2) if a charitable organization is designated as policy beneficiary, where this designation may be made with respect to all or any portion of the proceeds, but no charitable contributions deduction is allowable for such a designation; or

(3) if an employer is beneficiary (directly or indirectly), unless the employer is required to pay proceeds over to an employee's estate or beneficiary.[1]

Any contribution toward group-term life insurance, but not toward permanent benefits, made by an employee during a taxable year generally reduces, dollar for dollar, the amount that otherwise would be included in the employee's gross income for term insurance. This reduction is not permitted, however, if the employee makes a prepayment for coverage after retirement or for payments allocable to insurance where the cost is not taxed because of one of the exceptions outlined above.[2]

The exemption of the cost of up to $50,000 of group-term life is not available with respect to group-term insurance purchased under a qualified employees' trust or annuity plan. The provisions of IRC Section 72(m)(3) and Treasury Regulation Section 1.72-16 apply to the cost of the protection purchased under qualified plans and no part of the cost is excludable from an employee's gross income.[3]

Premiums for supplemental insurance in excess of $50,000 provided by an employer under a group-term insurance plan are not taxable to an insured employee when paid by a family member to whom the employee has assigned the insurance.[4] If the cost of the coverage in excess of $50,000 is shared by an employer and assignee, the employer's portion of the cost is includable in the insured employee's gross income.[5]

8724. Do any nondiscrimination requirements apply to Section 79 plans?

Yes. If a Section 79 plan covers any key employees and the plan discriminates in favor of them either as to eligibility to participate or with respect to the kind or amount of benefits, the key employees may not exclude the cost of the first $50,000 of coverage (see Q 8721). If a plan is found to be discriminatory, the key employee must include the higher of the actual cost for such insurance or the cost as specified in the uniform premium Table I (see Q 8722). Employees who are not key employees may exclude the cost of $50,000 of coverage even if a plan is discriminatory.[6]

1. IRC Sec. 79(b); Treas. Reg. §1.79-2; TRA '84 Sec. 223(d), as amended by TRA '86, Sec. 1827(b)(1); Temp. Treas. Reg. §1.79-4T, A-1. See also Let. Rul. 9149010.
2. Treas. Regs. §§1.79-2(a)(2), 1.79-3(g)(2).
3. IRC Sec. 79(b)(3); Treas. Reg. §1.79-2(d).
4. Rev. Rul. 71-587, 1971-2 CB 89.
5. Rev. Rul. 73-174, 1973-1 CB 43.
6. IRC Sec. 79(d).

A plan is considered discriminatory in favor of key employees with respect to eligibility to participate *unless*:

(1) it benefits at least 70 percent of all employees;

(2) at least 85 percent of participants are not key employees;

(3) the plan benefits a class of employees found by the IRS not to be discriminatory; or

(4) if the plan is part of a cafeteria plan, the requirements for cafeteria plans are met (see Q 8787).[1]

Individuals who do not need to be counted for the purposes of determining whether a plan is discriminatory include:

(1) employees with fewer than three years of service;

(2) part-time and seasonal employees;

(3) employees excluded from a plan who are covered by a collective bargaining agreement if group-term life insurance was the subject of good faith bargaining, and

(4) certain nonresident aliens.[2]

Benefits are discriminatory unless all benefits that are made available to key employee participants are available to all other participants.[3] Benefits are not discriminatory if the plan provides a fixed amount of insurance that is the same for all covered employees or merely because the amount of insurance bears a uniform relationship to the total compensation of employees, or to their basic or regular rate of compensation.[4] In other circumstances, the determination of whether a plan is nondiscriminatory will be based on all the facts and circumstances.[5]

For purposes of determining whether an employer's group-term insurance plan is discriminatory, all policies providing group-term life insurance to a key employee or key employees carried directly or indirectly by an employer will be treated as a single plan. An employer may treat two or more policies that do not provide group-term life insurance to a common key employee as a single plan.[6]

Who are Considered Key Employees?

A key employee is an employee who, at any time during the employer's tax year was:

1. IRC Sec. 79(d)(3)(A).
2. IRC Sec. 79(d)(3)(B).
3. IRC Sec. 79(d)(4).
4. IRC Sec. 79(d)(5); Treas. Reg. §1.79-4T, A-9.
5. Treas. Reg. §1.79-4T, A-9.
6. Treas. Reg. §1.79-4T, A-5.

(1) an officer of an employer having annual compensation greater than $160,000 in 2011, $165,000 in 2012 and 2013, and $170,000 in 2014. No more than the greater of (a) three individuals or (b) 10 percent of employees need to be treated as officers, but in any event no more than fifty individuals may be considered officers;

(2) a more-than-5 percent owner of an employer; or

(3) a more-than-1 percent owner, determined without considering those employees who are not counted in testing for discriminatory eligibility, having an annual compensation from an employer of more than $150,000.[1]

A key employee also is any former employee who was a key employee when he or she retired or separated from service.[2]

For purposes of determining corporate ownership, the attribution rules of IRC Section 318 apply. Rules similar to the attribution rules apply to determine non-corporate ownership. In calculating attribution from a corporation, a 5 percent ownership test will apply rather than a 50 percent test.

In determining the percentages of ownership, only the particular employer is considered; other members of a controlled group of corporations or businesses under common control and other members of an affiliated service group are not aggregated. They are aggregated for purposes of determining the employee's compensation and in testing for discrimination.[3]

Exemption for Church Plans

The nondiscrimination requirements discussed above do not apply to church plans for church employees. A church plan generally is one established by a church or convention or association of churches that is tax-exempt under IRC Section 501(c)(3). A church employee includes a minister, or an employee of an organization that is tax-exempt under IRC Section 501(c)(3), but does not include an employee of an educational organization above the secondary level, other than a school for religious training, or an employee of certain hospital or medical research organizations.[4]

1. IRC Secs. 79(d)(6), 416(i).
2. IRC Sec. 79(d)(6).
3. IRC Sec. 414(t); see also Temp. Treas. Reg. §1.79-4T, A-5.
4. IRC Sec. 79(d)(7).