PART III: BUSINESS LIFE INSURANCE

244. What is business life insurance?

Business life insurance is life insurance owned by a business, regardless of whether the business is a sole proprietorship, partnership, or corporation. The insurance can have a number of different purposes. For example, the insurance can be used to insure the life of a key employee, whose death could have a considerable negative impact on the business. The insurance could be purchased as part 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.

Premiums

In General

245. Are premiums paid on business life insurance deductible as business expenses?

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

IRC Section 264(a)(1) expressly provides that no deduction shall be allowed for premiums paid on any life insurance policy, or endowment or annuity contract, if a 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.[1] The rule under Section 264(a)(1) is an all or nothing rule. Even though the payer of a premium has a right to receive only a portion of the proceeds, the entire premium is nondeductible. The deduction cannot be divided but must either be allowed or disallowed in total.[2] The rule under Section 264(a)(1) applies regardless of the form of insurance, so it makes no difference whether premiums are paid on term, ordinary life, or endowment policies.

Deduction of a premium clearly is prohibited under Section 264(a)(1) where a taxpayer who is the payer of the premium is designated as the beneficiary in the policy. For example, premiums paid on key person insurance, where an employer normally is both owner and beneficiary of a policy, clearly are nondeductible by reason of IRC Section 264(a)(1). A deduction likewise is denied under Section 264(a)(1) where a premium payer is only indirectly a beneficiary under a policy. Thus, a deduction is 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.[3]

An employer is permitted to deduct premiums paid on insurance covering the life of an employee, however, if the employer is not directly or indirectly a beneficiary under the policy

1. Treas. Reg. §1.264-1(a).
2. Rev. Rul. 66-203, 1966-2 CB 104.
3. Rev. Rul. 70-148, 1970-1 CB 60; Rev. Rul. 66-203, supra.

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and the premiums represent additional reasonable compensation for services rendered by an 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, premiums ordinarily are deductible by the employer as additional compensation to the employee.[1] The deduction will not be denied merely because an employer may derive some benefit indirectly from the increased efficiency of an employee.[2]

246. Are premiums paid on business life insurance taxable income to an insured?

Premiums generally are not taxable to an insured if the insurance is purchased for the benefit of the business and the insured has no interest in the policy. 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.[3]

If life insurance premiums are paid by an employer on a policy insuring the life of an employee and the proceeds are payable to a beneficiary of the employee, there generally is some taxable income to the employee (Q 252, Q 254). There are exceptions to this general rule in the case of group life insurance (Q 229) and qualified pension and profit sharing plans (Q 3843).

Corporations and Stockholders: Deductibility

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

It may not do so under IRC Section 264(a)(1) if it either is directly or indirectly a beneficiary under the policy (Q 245). This is true even if a 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). Even though a corporation may have no right to the cash value of a policy, and no right to name or change the beneficiary, the corporation cannot deduct the premiums if the policy proceeds are to be used in payment for stock that is to be surrendered to the corporation. In this case, the deduction is not allowed because the premium payments are not ordinary and necessary business expenses but are capital expenditures because they are payments for the acquisition of a corporate asset: treasury stock.[5]

1. IRC Sec. 162(a); Treas. Reg. §1.162-7.
2. Treas. Reg. §1.264-1(b).
3. *Casale v. Comm.*, 247 F.2d 440 (2d Cir. 1957); *U.S. v. Leuschner*, 14 AFTR 2d 5599, 336 F. 2d 246 (9th Cir 1964) *Lacey v. Comm.*, 41 TC 329 (1963), *acq*. 1964-2 CB 6; Rev. Rul. 59-184, 1959-1 CB 65.
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.

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On the other hand, 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, premium payments must constitute reasonable compensation.[2] The question of whether compensation is reasonable can arise in the case of a stockholder-employee of a close corporation. If the total amount paid to and on behalf of a stockholder-employee is an unreasonable return for his or her 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 there is no evidence, such as board of directors' minutes, to show that premium payments were intended as compensation.[3]

The deduction certainly will be disallowed where surrounding circumstances affirmatively show that premiums were not paid as compensation. 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, they were not compensation, but dividends. The policies were owned by the stockholder-employees and proceeds were payable to their personal beneficiaries. The insureds 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.

In the case of an S corporation, see Q 256.

248. If a stockholder pays premiums on insurance on the life of one of the corporation's officers and the corporation is beneficiary of the proceeds, may the stockholder deduct the premium payments as business expenses?

No.

The premium payments are not related to the taxpayer's trade or business. The business of the corporation is not the stockholder's business.[5]

249. If a stockholder purchases insurance on the life of another stockholder to fund his or her obligations under a cross purchase plan, can the stockholder deduct the premiums he or she pays on the policy?

No.

The premium payments are in the nature of capital expenditures. That is, they are amounts paid to acquire a capital asset.[6]

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. Atlas Heating and Ventilating Co. v. Comm., 18 BTA 389 (1929).
5. *Cappon v. Comm.*, 28 BTA 357 (1933).
6. Rev. Rul. 70-117, 1970-1 CB 30; *Whitaker v. Comm.*, 34 TC 106 (1960).

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Corporations and Stockholders: Includable in Income

250. Where a key person life insurance policy is owned by and payable to an employer corporation, are premiums paid by the corporation taxable to the key person?

No.[1]

In *Casale*, 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 president's life, which the corporation had purchased to hedge its obligation to the insured under a deferred compensation agreement. The Tax Court held that premiums paid by the corporation were taxable income to the insured. The Second Circuit reversed, 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. The IRS has agreed to follow the Second Circuit's decision as precedent in dealing with similar cases.[2]

However, see *Goldsmith v. U.S.* (Q 3553).[3]

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

No.

The premiums are not income to a stockholder even though the stockholder has the right to designate the beneficiary, provided the beneficiary's right to receive the proceeds is conditioned on the transfer of stock to the corporation.[4]

Likewise, premiums are not taxable income to an insured stockholder when a trustee is named beneficiary, provided the trustee is obligated to use the proceeds to purchase the insured's stock for the corporation.[5]

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

Yes.[6] If dividends are applied to reduce current premiums, only the net premium is taxable income to the employee.[7]

As a rule, the premium payments are considered additional compensation to the employee and therefore deductible by the employer. If an employer is a close corporation and the employee

1. *Casale v. Comm.*, 247 F.2d 440 (2d Cir. 1957); Rev. Rul. 59-184, 1959-1 CB 65.
2. Rev. Rul. 59-184, supra. See also: *Lacey v. Comm.*, 41 TC 329 (1963), *acq.*, 1964-2 CB 6.
3. *Goldsmith v U.S.*,78-1 USTC ¶9312 (Ct. Cl. 1978).
4. *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.
5. Rev. Rul. 70-117, 1970-1 CB 30.
6. 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).
7. *Weeks v. Comm.*, 16 TC 248 (1951); *Sturgis v. Comm.*, 10 TCM (CCH) 136.

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a stockholder, the IRS may contend they are dividends taxable to the insured but not deductible by the corporation (Q 247; in the case of an S corporation, see Q 256).

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, the payment of premiums on the insurance was considered an economic benefit to the employee and as such includable in the employee's gross income.[1]

Where a stockholder-employee contends that premiums paid by the corporation on the employee's personal insurance were merely loans, the premiums will be taxed to the employee as dividends unless the employee can produce evidence to show that the employee intended to reimburse the corporation for its outlays.[2]

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

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 (Q 251), the tax results of the arrangement are uncertain. The regulations state: "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."[3] This suggests that the entire premium is taxable to the employee.

In one case, where an employee's beneficiary was named irrevocably, the full premiums were taxed to the employee even though the corporation owned the policy.[4]

Where a corporation owned a policy designating an insured employee's family as beneficiary and could change the beneficiary, premium payments were not income to the employee.[5] The Tax Court suggested that the P.S. 58 costs might be taxable to the employee each year the employee's family is beneficiary. After 2001, P.S. 58 rates generally may not be used, but Table 2001 may be used (Q 3903).

Planning Point. To avoid confusion on the tax results when premiums are paid by a business but the policy beneficiary is someone other than the business, it is important to properly document the transaction. If the transaction is intended to be a loan it is important to have signed loan documents and to either pay or account for the accrued interest on an ongoing basis. If the arrangement is economic benefit split dollar, then a split dollar agreement should be executed and payment of economic benefit costs should be made annually.

1. *Brock v. Comm.*, TC Memo 1982-335; *Champion Trophy Mfg. Corp. v. Comm.*, TC Memo 1972-250; see IRC Sec. 301(c).
2. *Schwartz v. Comm.*, TC Memo 1963-340.
3. Treas. Reg. §1.61-2(d)(2)(ii)(A).
4. *Comm. v. Bonwit*, 87 F.2d 764 (2nd Cir. 1937).
5. *Rodebaugh v. Comm.*, TC Memo 1974-36, *aff'd*, 518 F. 2d 173, 75-2 USTC ¶9526 (6th Cir. 1975), but this point was not appealed.

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254. If a corporation pays life insurance premiums on policies owned by stockholders and the policies are used to fund a cross purchase agreement, are premium payments taxable income to stockholders?

Yes.

They are considered distributions of dividends to the stockholders who own the policies.[1]

Planning Point. Depending on the situation, treatment as ordinary income rather than as a dividend may be preferred. If ordinary income treatment is preferred, the corporation (assuming total compensation remains reasonable) could increase compensation to the stockholders who could pay the premiums themselves.

In the case of an S corporation, see Q 256.

Corporations and Stockholders: Section 162 Bonus Plan

255. What is a Section 162 bonus plan and what are the income tax consequences to an employee and employer?

An IRC Section 162 bonus plan or an executive bonus plan is a nonqualified employee benefit arrangement in which an employer pays a compensation bonus to a selected employee who then uses the bonus payment to pay premiums on a life insurance policy insuring his or her life. The policy is owned personally by the employee.

A compensation bonus generally is deductible to a corporate employer if an employee's total compensation is a reasonable amount.[2] Whether used to pay policy premiums or not (Q 252), a compensation bonus is includable in gross income to an employee.[3] At death, policy death proceeds are received by an employee's beneficiary income tax-free (Q 62).[4] Any policy withdrawals, surrenders, or loans made by an employee are taxed as they would be if the employee had purchased the policy without the benefit of the bonus arrangement (Q 10, Q 13, Q 30).

S Corporations

256. What are the tax consequences when an S corporation pays a premium on a life insurance policy insuring a shareholder or employee?

An S corporation generally does not pay taxes; instead, items of income, deduction, loss, and credit are passed through to shareholders who report their pro rata shares on their individual returns. 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 (Q 247 to Q 254). The resulting tax treatment of the shareholders would differ in some instances.

1. *Doran v. Comm.*, 246 F.2d 934 (9th Cir. 1957); Rev. Rul. 59-184, 1959-1 CB 65.
2. IRC Sec. 162(a)(1), Treas. Reg. §1.162-9.
3. IRC Sec. 61(a).
4. IRC Sec. 101(a)(1).

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Where the payment is a nondeductible expense, as it would be if a corporation was both owner and beneficiary of a key person policy, each shareholder reduces his or her basis in his or her shares by his or her proportionate part of the nondeductible expense.[1]

If particular premium payments are considered compensation as in the example where an employee owns a policy or has a beneficial interest in it (Q 252 to Q 254), the amount of compensation would be deductible in determining the corporation's income or loss that is reported pro rata by each shareholder. The amount of compensation then would be included in income by the insured employee.[2]

If a premium payment is considered a distribution with respect to stock to an individual shareholder (Q 252, Q 254), the tax treatment would depend on whether or not a 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.[3] 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.

Planning Point: An S corporation cannot have more than one class of stock. In order to avoid an inadvertent termination of the S election, care must be taken to avoid treating shareholders differently. In Private Letter Ruling 9735006, the Treasury ruled that a split dollar agreement between a single shareholder and the S corporation did not create a second class of stock because the split dollar arrangement required reimbursement for premiums paid. Arrangements not involving reimbursement, however, could be problematic. Before an S corporation pays insurance premiums, a qualified tax advisor should be consulted.

In a revenue ruling issued in 2008, the IRS outlined the effects of premiums paid by an S corporation on an employer-owned life insurance ("EOLI") contract 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, of which the S corporation is directly or indirectly a beneficiary, do not reduce the S corporation's AAA, and 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.[4]

Partnerships and Partners

257. Are premiums deductible when paid by a partnership or by a partner for insurance on the life of a copartner?

No.

This is true regardless of who is named beneficiary. Premiums paid for any life insurance, or endowment or annuity contract, are not deductible if a taxpayer is directly or indirectly a

1. IRC Sec. 1367(a)(2)(D).
2. IRC Secs. 1363, 1366.
3. IRC Sec. 1368.
4. Rev. Rul. 2008-42, 2008-30 IRB 175.

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beneficiary under the policy or contract.[1] Whether insurance is purchased as a key person policy or to finance the purchase of an insured's partnership interest, the premium paying partner will benefit from the policy.[2] For insurance purchased by a partnership on the life of an employee who is not a partner, see Q 245 and Q 246.

258. What credit is available for small employers for employee health insurance expenses?

A credit is available for employee health insurance expenses of an eligible small employer for taxable years beginning after December 31, 2009, provided the employer offers health insurance to its employees.[3]

An eligible small employer is an employer that has no more than twenty-five full time employees, the average annual wages of whom do not exceed $50,000 (in 2010, 2011, 2012, and 2013; the amount is indexed thereafter).[4]

An employer must have a contribution arrangement for each employee who enrolls in the health plan offered by the employer through an exchange that requires that the employer make a non-elective contribution in an amount equal to a uniform percentage, not less than 50 percent, of the premium cost.[5]

Subject to phase-out[6] based on the number of employees and average wages, the amount of the credit is equal to 50 percent, and 35 percent in the case of tax exempts, of the lesser of (1) the aggregate amount of non-elective contributions made by the employer on behalf of its employees for health insurance premiums for health plans offered by the employer to employees through an exchange, or (2) the aggregate amount of non-elective contributions the employer would have made if each employee had been enrolled in a health plan that had a premium equal to the average premium for the small group market in the ratings area.[7]

For years 2010, 2011, 2012, and 2013, the following modifications apply in determining the amount of the credit:

(1) the credit percentage is reduced to 35 percent (25 percent in the case of tax exempts);[8]

(2) the amount under (1) is determined by reference to non-elective contributions for premiums paid for health insurance, and there is no exchange requirement;[9] and

1. IRC Sec. 264(a)(1).
2. Treas. Reg. §1.264-1.
3. IRC Sec. 45R, as added by PPACA 2010.
4. IRC Secs. 45R(d), as added by PPACA 2010; IRC Sec 45R(d)(3)(B), as amended by Section 10105(e)(1) of PPACA 2010.
5. IRC Sec. 45R(d)(4), as added by PPACA 2010.
6. IRC Sec. 45R(c), as added by PPACA 2010.
7. IRC Sec. 45(b), as added by PPACA 2010.
8. IRC Sec. 45R(g)(2)(A), as added by PPACA 2010.
9. IRC Secs. 45R(g)(2)(B), 45R(g)(3), as added by PPACA 2010.

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(3) the amount under (2) is determined by the average premium for the state small group market.[1]

The credit also is allowed against the alternative minimum tax.[2]

In 2014 small employers will have exclusive access to an expanded Small Business Healthcare Tax Credit under the Affordable Care Act. This tax credit covers as much as 50% of the employer contribution toward premium costs for eligible employers who have low- to moderate-wage workers.

Sole Proprietorships

259. Is the value of employer-provided coverage under accident or health insurance taxable income to an employee?

Generally, no.

This includes medical expense and dismemberment and sight loss coverage for the employee, his or her spouse and dependents, and coverage providing for disability income for the employee (Q 305). There is no specific limit on the amount of employer-provided coverage that may be excluded from an employee's gross income. Coverage is tax-exempt to an employee whether it is provided under a group or individual insurance policy.[3] Coverage under an uninsured plan is explained in Q 261.

Likewise, the value of critical illness coverage is not taxable income to an employee.

Accidental death coverage is excludable from an employee's gross income under IRC Section 106(a).[4]

In a Private Letter Ruling, the IRS decided that the value of consumer medical cards purchased by a partnership for its employees was excludable from the employees' income under IRC Section 106(a).[5]

Where an employer applies salary reduction amounts to the payment of health insurance premiums for employees, the salary reduction amounts are excludable from gross income under IRC Section 106.[6]

If an employee pays the premiums on his or her personally-owned medical expense insurance and is reimbursed by his or her employer, the reimbursement likewise is excludable from the employee's gross income under IRC Section 106.[7]

1. IRC Sec. 45R(g)(2)(C), as added by PPACA 2010.
2. IRC Sec. 38(c)(4)(B), as amended by PPACA 2010. The IRS has issued guidance; see IRS Notice 2010-44, 2010-22 I.R.B. 717; IRS Notice 2010-82, 2010-51 I.R.B. 1.
3. IRC Sec. 106(a). See also Treas. Reg. §1.106-1; Rev. Rul. 58-90, 1958-1 CB 88; Rev. Rul. 56-632, 1956-1 CB 101.
4. See Treas. Reg. §1.106-1; Treas. Reg. §1.79-1(f)(3); Let. Ruls. 8801015, 8922048.
5. Let. Rul. 9814023.
6. Rev. Rul. 2002-03, 2002-1 CB 316.
7. See Rev. Rul. 61-146, 1961-2 CB 25; see *Larkin v. Comm.*, 48 TC 629 (1967), Footnote #3; Let. Rul. 9840044.

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Where an employer simply pays an employee or retiree a sum that may be used to pay the premium but that amount is not required to be used for that purpose, the amount is taxable to the employee.[1]

According to the IRS, where an employer, not pursuant to a cafeteria plan under IRC Section 125 (Q 3501), offers an employee a choice between a lower salary and employer-paid health insurance or a higher salary and no health insurance, the employee must include the full amount of the higher salary in income regardless of his or her choice. An employee selecting the health insurance option is considered to have received the higher salary and, in turn, paid a portion of the salary equal to the health insurance premium to the insurance company.[2]

A federal district court faced with a similar fact situation has ruled that for employees who accept employer-paid health insurance coverage, the difference between the higher salary and the lower one is not subject to FICA and FUTA taxes or to income tax withholding.[3]

Where a taxpayer's contribution to a fund providing retiree health benefits is deducted from the taxpayer's after-tax salary, it is considered an employee contribution and is includable in the taxpayer's income under IRC Section 61.

In contrast, where an employer increases or grosses up a taxpayer's salary and then deducts the fund contribution from the taxpayer's after-tax salary, the contribution is considered to be an employer contribution that is excludable from the gross income of the taxpayer under IRC Section 106.[4]

A return of premium rider on a health insurance policy was ruled a benefit in addition to accident and health benefits and the premium paid by the employer was not excludable by the employee.[5]

Employer-provided accident and health coverage for an employee and the employee's spouse and dependents, both before and after retirement, and for the employee's surviving spouse and dependents after the employee's death, does not have to be included in gross income by the active or retired employee or, after the employee's death, by the employee's survivors.[6]

Expanded Income Exclusion for Adult Children's Coverage

Under the Patient Protection and Affordable Care Act of 2010 ("PPACA 2010"), the exclusion from gross income for amounts expended on medical care is expanded to include employer provided health coverage for any adult child of the taxpayer if the adult child has not attained the age of twenty-seven as of the end of the taxable year. According to Notice 2010-38, the

1. Rev. Rul. 75-241, 1975-1 CB 316, Let. Rul. 9022060. See also Let. Rul. 9104050.
2. Let. Rul. 9406002. See also Let. Rul. 9513027.
3. *Express Oil Change, Inc. v. U.S.*, 25 F. Supp. 2d 1313 78 AFTR2d 96-6764 (N.D. Ala. 1996), *aff'd,166 F. 3d 1290*, 83 AFTR2d 99-302 (11th Cir. 1998).
4. Let. Rul. 9625012.
5. Let. Rul. 8804010.
6. Rev. Rul. 82-196, 1982-2 CB 53; GCM 38917 (11-17-82).

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adult child does not have to be eligible to be claimed as a dependent for tax purposes for this income exclusion to apply.[1]

If an employer's accident and health plan continues to provide coverage pursuant to a collective bargaining agreement for an employee who is laid off, the value of the coverage is excluded from the gross income of the laid-off employee.[2] Terminated employees who receive medical coverage under a medical plan that is part of the former employer's severance plan are considered to be employees for purposes of IRC Sections 105 and 106. Thus, an employer's contributions toward medical care for employees are excludable from income under IRC Section 106.[3] Otherwise, the exclusion is available only to active employees.

Full time life insurance salespersons are considered employees if they are employees for Social Security purposes.[4] Coverage for other commission salespersons is taxable income to the salespersons, unless an employer-employee relationship exists.[5] In the case of shareholder-employees owning more than 2 percent of the stock of an S corporation, see Q 272.

Discrimination generally does not affect exclusion of the value of coverage. Even if a self-insured medical expense reimbursement plan discriminates in favor of highly compensated employees, the value of coverage is not taxable; only reimbursements are affected (Q 262).

Beginning in January 2012, The Affordable Care Act requires employers to report the cost of coverage under an employer-sponsored group health plan.

The fact that the cost of an employee's health care benefits is shown on the employee's Form W-2 does not mean that the benefits are taxable to the employee. There is nothing about the reporting requirement that causes or will cause excludable employer-provided health coverage to become taxable. The purpose of the reporting requirement is to provide employees useful and comparable consumer information on the cost of their health care coverage.

260. What are the tax consequences of payments received by employees under employer-provided accident or health insurance?

Although the amounts that both employers and employees pay for premiums for employer sponsored health and accident insurance plans must now be stated on the employee's Form W-2, the tax consequences of receiving benefits pursuant to those plans have not changed. However, some payments must be included in the employee's gross income, explained below.

Hospital, Surgical, and Medical Expenses

Amounts received by an employee under employer-provided accident or health insurance, group or individual, that reimburse the employee for hospital, surgical, and other medical

1. IRC Sec. 105(b), as amended by the Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Reconciliation Act of 2010. Notice 2010-38, 2010-20 IRB 682.
2. See Rev. Rul. 85-121, 1985-2 CB 57.
3. Let. Rul. 9612008.
4. IRC Sec. 7701(a)(20).
5. Rev. Rul. 56-400, 1956-2 CB 116; see also IRC Sec. 3508.

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expenses incurred for care of the employee or his or her spouse and dependents generally are tax-exempt without limit.

Nonetheless, benefits must be included in gross income to the extent that they reimburse an employee for any expenses that the employee deducted in a prior year. Moreover, if reimbursements exceed actual expenses, the excess must be included in gross income to the extent that it is attributable to employer contributions.[1]

Where an employer reimburses employees for salary reduction contributions applied to the payment of health insurance premiums, these amounts are not excludable under IRC Section 105(b) because there are no employee-paid premiums to reimburse.[2]

Likewise, where an employer applies salary reduction contributions to the payment of health insurance premiums and then pays the amount of the salary reduction to employees regardless of whether the employee incurs expenses for medical care, these so-called advance reimbursements or loans are not excludable from gross income under IRC Section 105(b) and are subject to FICA and FUTA taxes.[3]

Sight Loss and Dismemberment Benefits

Payments not related to absence from work for the permanent loss, or loss of use, of a member or function of a body or permanent disfigurement of the employee or his or spouse or a dependent are excluded from income if the amounts paid are computed with reference to the nature of the injury.[4]

A lump-sum payment for incurable cancer under a group life-and-disability policy qualified for tax exemption under this provision.[5]

Benefits determined by length of service rather than type and severity of injury did not qualify for the exemption.[6]

Benefits determined as a percentage of a disabled employee's salary rather than the nature of the employee's injury were not excludable from income.[7] An employee who has permanently lost a bodily member or function but is working and drawing a salary cannot exclude a portion of that salary as payment for loss of the member or function if that portion was not computed with reference to the loss.[8]

1. IRC Sec. 105(b); Treas. Reg. §1.105-2; Rev. Rul. 69-154, 1969-1 CB 46.
2. Rev. Rul. 2002-3, 2002-1 CB 316.
3. Rev. Rul. 2002-80, 2002-2 CB 925.
4. IRC Sec. 105(c).
5. Rev. Rul. 63-181, 1963-2 CB 74.
6. *Beisler v. Comm.*, 814 F.2d 1304 (9th Cir. 1987); *West v. Comm.*, TC Memo 1992-617. See also *Rosen v. U.S.*, 829 F.2d 506 (4th Cir. 1987).
7. *Colton v. Comm.*, TC Memo 1995-275; *Webster v. Comm.*, 870 F. Supp 202, 94-2 USTC ¶50,586 (M.D. Tenn. 1994).
8. *Laverty v. Comm.*, 61 TC 160 (1973) *aff'd*, 523 F.2d 479, 75-2 USTC ¶9712 (9th Cir. 1975).

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Critical Illness Benefits

Amounts received by an employee under employer-provided critical illness policies where the value of the coverage was not includable in the employee's gross income are includable in the employee's gross income. The exclusion from gross income under IRC Section 105(b) applies only to amounts paid specifically to reimburse medical care expenses. Because critical illness insurance policies pay a benefit irrespective of whether medical expenses are incurred, these amounts are not excludable under IRC Section 105(b).[1]

Wage Continuation and Disability Income

Sick pay, wage continuation payments, and disability income payments, both preretirement and postretirement, generally are fully includable in gross income and taxable to an employee (Q 305).[2]

Accidental Death Benefit

Accidental death benefits under an employer's plan are received income tax-free by an employee's beneficiary under IRC Section 101(a) as life insurance proceeds payable by reason of the insured's death.[3] Death benefits payable under life insurance contracts issued after December 31, 1984, are excludable only if the contract meets the statutory definition of a life insurance contract in IRC Section 7702 (Q 32).

Survivors' Benefits

Benefits paid to a surviving spouse and dependents under an employer accident and health plan that provided coverage for an employee and the employee's spouse and dependents both before and after retirement, and to the employee's surviving spouse and dependents after the employee's death, are excludable to the extent that they would be if paid to the employee.[4]

Deduction of Premiums Denied for Reasons Other Than Section 264(a)(1)

261. Are benefits provided under an employer's noninsured accident and health plan excludable from an employee's income?

To be tax-exempt on the same basis as insured plans (Q 259, Q 260), uninsured benefits must be received under an accident and health plan for employees.[5] Although there must be a plan for uninsured payments, the plan need not follow a particular legal form. According to an Ohio federal District Court[6], there is no legal magic to a form; the essence of the arrangement must determine its legal character. The fact that there is no formal contract of insurance

1. See Treas. Regs. §§1.105-2, 1.213-1(e).
2. See Let. Ruls. 9103043, 9036049.
3. Treas. Reg. §1.101-1(a).
4. Rev. Rul. 82-196, 1982-2 CB 53; GCM 38917 (11-17-82).
5. IRC Sec. 105(e).
6. Epmeier v. U.S., 199 F.2d 508 (7th Cir., 1959)

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is immaterial, if it is clear that, for an adequate consideration, the company has agreed and has become liable to pay and has paid sickness benefits based upon a reasonable plan of protection of its employees.

Thus, a provision for disability pay in an employment contract has been held to satisfy the condition.[1]

It is not necessary for tax purposes that a plan be in writing or that an employee's rights to benefits under the plan be enforceable. For example, an employer's custom or policy of continuing wages during disability, generally known to employees, has been held to constitute a plan.[2]

If an employee's rights are not enforceable, the employee must have been covered by a plan or a program, policy, or custom having the effect of a plan when the employee became sick or injured, and notice or knowledge of the plan must have been readily available to the employee.[3] For there to be a plan, an employer must commit to certain rules and regulations governing payment and these rules must be made known to employees as a definite policy before accident or sickness arises; *ad hoc* payments at the complete discretion of an employer do not qualify as a plan.[4]

The plan must be for employees. A plan may cover one or more employees and there may be different plans for different employees or classes of employees.[5] A plan that is found to cover individuals in a capacity other than their employee status, even though they are employees, is not a plan for employees (Q 271). Self-employed individuals and certain shareholders owning more than 2 percent of the stock of an S corporation are not treated as employees for the purpose of determining the excludability of employer-provided accident and health benefits (Q 272).[6]

In addition, uninsured medical expense reimbursement plans for employees must meet nondiscrimination requirements for medical expense reimbursements to be tax-free to highly compensated employees (Q 262).

Planning Point: The most important concept surrounding Section 105 Plans is *legitimate employment* between spouses or any other named employee. This issue is closely scrutinized by the IRS, and it is absolutely vital that the relationship be in existence. Fabricated relationships are absolutely discouraged. Therefore, having the following items in place helps to ensure the plan operates smoothly and the tax advantages are maximized:

1. Written employment agreements

2. Logs of hours worked by employees

3. Established cash (salary) compensation payment amounts and schedules

1. Andress v. U.S., 198 F. Supp. 371 (N.D. Ohio, 1961).
2. *Niekamp v. U.S.*, 240 F. Supp. 195 (E.D. Mo. 1965); *Pickle*, TC Memo 1971-304.
3. Treas. Reg. §1.105-5(a).
4. *Est. of Kaufman*, 35 TC 663 (1961), *aff'd*, 300 F.2d 128 (6th Cir. 1962); *Lang*, 41 TC 352 (1963); *Levine*, 50 TC 422 (1968); *Est. of Chism*, TC Memo 1962-6, *aff'd*, 322 F.2d 956 (9th Cir. 1963); *Burr*, TC Memo 1966-112; *Frazier v. Comm.*, TC Memo 1994-358; *Harris*, 77-1 USTC ¶9414 (E.D. Va. 1977).
5. Treas. Reg. §1.105-5(a); Andress v. U.S., supra.
6. IRC Sec. 105(g); Treas. Reg. §1.105-5(b).

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In addition, it is recommended to:

1. Name the insured (it is preferred that the insurance policy be in the employee's name).

2. Maintain separate checking accounts (one for business use and the second for personal use).

3. Pay for medical expenses (all medical expenses for the family should be paid by the employee from his or her personal account), and the employee should document all payments.

Living Proceeds Received by a Corporation

262. How is a corporation taxed on payments under an annuity contract or on living proceeds from an endowment or life insurance contract?

With respect to the tax consequences to a corporation under an annuity or on living proceeds from endowment and life insurance contracts, the same rules apply that are applicable to personal insurance and endowment contracts (Q 10 to Q 61).[1] The same rules that apply to increases in the cash value of policies for personal insurance (Q 8) also apply to business-owned insurance.

To the extent that contributions are made after February 28, 1986 to a deferred annuity contract held by a corporation or other entity that is not a natural person, the contract is not treated for tax purposes as an annuity contract. Income on the contract is treated as ordinary income received or accrued by the owner during the taxable year.[2] Thus, if payments received in a year plus amounts received in prior years plus the net surrender value at the end of the year, if any, exceed premiums paid in the year and in prior years plus amounts included in income in prior years, the excess amount is includable in income. The rule and exceptions are discussed in Q 439.

To the extent an annuity contract is not subject to this rule, payments received under the contract will be subject to the rules applicable to personal annuity contracts.

Death Proceeds of Business Life Insurance

In General

263. Are death proceeds of business life insurance exempt from income tax?

Under rules applicable to life insurance contracts generally, the entire lump sum payable at an insured's death is ordinarily exempt from regularly calculated income tax whether the beneficiary is an individual, a corporation, a partnership, a trust, or the insured's estate (Q 63, Q 64).[3]

See below for employer-owned life insurance contracts entered into after August 17, 2006.

If proceeds are paid out under a life income or other installment option, the amount payable at death may be prorated and recovered from the payments in equal tax-free amounts over the

1. See IRC Sec. 11(a).
2. IRC Sec. 72(u).
3. IRC Sec. 101(a); Treas. Reg. §1.101-1(a).

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payment period, but the interest element is taxable (Q 70). 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 (Q 256, Q 276).

Death proceeds are not always wholly tax-exempt. For example, the IRC expressly provides that proceeds are taxable, under some circumstances, where a policy has previously been sold or otherwise transferred for a valuable consideration (Q 264 to Q 275).

The IRC also provides a special rule for proceeds payable under a qualified pension or profit sharing plan; there, only the amount in excess of the cash surrender value is tax-exempt under IRC Section 101(a) (Q 3865 to Q 3867).

The same rule applies to proceeds received under a tax sheltered annuity (Q 3959) and proceeds received under individual retirement endowment contracts (Q 3627).

There are other instances, too, where the exemption is not available because proceeds are not considered to be received as life insurance proceeds. These include proceeds that are taxable as dividends or compensation (Q 276), proceeds taxable because of lack of insurable interest (Q 277), proceeds taxable as a return of embezzled funds (Q 278), and proceeds of creditor insurance (Q 131, Q 134).

Even though proceeds are tax-exempt, it has been ruled they can reduce an otherwise deductible capital loss. 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 express 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."[1]

For the treatment of proceeds under the alternative minimum tax, see Q 300.

Contracts Entered Into After August 17, 2006

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.

One set of requirements is that before an employer-owned life insurance contract is issued, an employer must meet certain notice and consent requirements. An insured employee must be notified in writing that the employer intends to insure the employee's life and the maximum face amount the employee's life could be insured for at the time the contract is issued. The notice also must state that the policy owner will be the beneficiary of the death proceeds of the policy. The insured also must give written consent to be the insured under the contract and consent to coverage continuing after the insured terminates employment.[2]

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

Another set of requirements relates to an insured's status with an employer. The insured must have been an employee at any time during the twelve month period before his or her death or a director or highly compensated employee at the time the contract was issued. A highly compensated employee is an employee classified as highly compensated under the qualified plan rules of IRC Section 414(q) except for the election regarding the top paid group (Q 3829), or under rules regarding self-insured medical expense reimbursement plans of IRC Section 105(h) (Q 322), except that the highest paid 35 percent instead of 25 percent will be considered highly compensated.[1]

Alternatively, 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 amount is paid to:

(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.

If death proceeds are used to purchase an equity interest from a family member, beneficiary, trust, or estate, the proceeds will not be included in an employer's income.[2]

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 and that person or entity, or certain related persons, is a beneficiary under the contract, and the contract covers the life of an insured who is an employee when the contract is issued.[3]

In addition, the Pension Protection Act of 2006 ("PPA 2006") imposes new reporting requirements on all employers owning one or more employer-owned life insurance contracts. Final reporting regulations were issued in November 2008.[4] In addition, the IRS released Notice 2009-48 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, both of which were enacted under PPA 2006. The guidance, which conveniently 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.[5]

1. IRC Sec. 101(j)(2)(A).
2. IRC Sec. 101(j)(2)(B).
3. IRC Sec. 101(j)(3)(A).
4. IRC Sec. 6039I; T.D. 9431, 73 Fed. Reg. 65981 (11-6-2008).
5. Notice 2009-48, 2009-24 IRB 1085.

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Proceeds Taxable Because of Transfer for Value

264. Will a sale or other transfer for value of an existing life insurance policy or any interest in a policy cause loss of income tax exemption for death proceeds?

Yes, as a general rule.

IRC Section 101(a)(2) provides that if a policy or any interest in a policy is transferred for a valuable consideration, 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).[1] This provision regarding interest paid or accrued applies to contracts issued after June 8, 1997, in taxable years ending after this date. 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.[2]

The balance of death proceeds is taxable as ordinary income. This is the so-called 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) If the sale or other transfer for value is to the insured (Q 267);[3]

(2) If 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 (Q 270 to Q 275).[4] Members of a limited liability company ("LLC") taxed as a partnership are considered to be partners for this purpose;[5] and

(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 (Q 275), where a policy is transferred between spouses (Q 101), or where a policy is acquired in part by gift (Q 74).[6]

Planning Point: Notice that the exceptions include transfers to a partner of the insured or a partnership in which the insured is a partner. But, notice that the exception only includes a transfer to a corporation in which the insured is an officer or shareholder; it does not include a transfer to another officer or shareholder.

1. IRC Sec. 101(a)(2).
2. TRA '97, Sec. 1084(d).
3. IRC Sec. 101(a)(2)(B).
4. IRC Sec. 101(a)(2)(B).
5. Let. Rul. 9625013.
6. IRC Sec. 101(a)(2)(A); Rev. Rul. 69-187, 1969-1 CB 45; Let. Rul. 8951056.

265. What is a transfer for value of a life insurance policy or an interest in a policy?

Any transfer for a valuable consideration of a right to receive all or part of the proceeds of a life insurance policy is a transfer for value. The transfer for value rule extends far beyond outright 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.

On the other hand, a mere pledging or assignment of a policy as collateral security is not a transfer for value.[1] A transfer of a policy by a corporation to a stockholder as a distribution in liquidation is a transfer for value.[2] A transfer for value can occur even though the policy transferred has no cash surrender value.[3] A transfer will be considered a transfer for value even though no purchase price is paid for the policy or interest in the policy, provided the transferor receives some other valuable consideration.[4]

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. On 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. Consequently, 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.[5]

There was a transfer for value where two shareholders assigned to each other existing policies that had no cash values on their own lives to fund a cross-purchase agreement.[6]

Similarly, where a partnership named two partners as cross-beneficiaries on policies owned by the partnership, a transfer for value had taken place.[7]

If a transferor receives no valuable consideration whatsoever, there is no transfer for value.[8]

The transfer of a policy to a grantor trust treated as owned by the transferor was not a transfer for value where the insureds, terms, conditions, benefits, and beneficial interests other than naming the trustee as beneficiary and nominal owner did not change.[9]

1. Treas. Reg. §1.101-1(b)(4).
2. *Lambeth v. Comm.*, 38 BTA 351 (1938).
3. *James F. Waters, Inc. v. Comm.*, 160 F.2d 596 (9th Cir. 1947).
4. *Monroe v. Patterson*, 197 F. Supp. 146 (N.D. Ala. 1961).
5. *Monroe v. Patterson*, supra.
6. Let. Rul. 7734048.
7. Let. Rul. 9012063.
8. *Haverty Realty & Investment Co. v. Comm.*, 3 TC 161 (1944).
9. Let. Rul. 9041052.

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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.[1] See Q 268 for a more detailed discussion of the application of the transfer for value rule in a situation involving multiple grantor trusts.

The replacement of a jointly owned policy with two separately owned policies was also not a transfer for value.[2]

Other rules govern transfer to a grantor trust owned by an insured (Q 267 and Q 268) and transfers of policies to a qualified retirement plan (Q 3865).

266. Is the transfer of a life insurance policy subject to a nonrecourse loan a transfer for value that could cause the loss of tax-free treatment of the proceeds?

Since 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.[3] Thus, there may be a transfer for value when a life insurance contract is transferred that is subject to a policy loan. 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 determinable in part by reference to the basis of the policy in the hands of the transferor (Q 264).[4]

In Letter Ruling 8951056, the gratuitous transfer of a policy subject to a nonrecourse loan was held part gift, part 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 and thus the transfer fell within the same exception to the transfer for value rule.[5]

267. Are benefits received under a personal health insurance policy taxable income?

No.

All kinds of benefits from personal health insurance generally are entirely exempt from income tax. This includes disability income; (Q 306), dismemberment and sight loss benefits; critical illness benefits;[6] and hospital, surgical, or other medical expense reimbursement. There is no limit on the amount of benefits, including the amount of disability income, that can be received tax-free under personally paid health insurance or under an arrangement having the effect of accident or health insurance.[7] At least one court has held, however, that the IRC Section

1. Rev. Rul. 2007-13, 2007-11 IRB 684.
2. Let. Rul. 9852041.
3. Treas. Reg. §1.1001-2(a).
4. Rev. Rul. 69-187, 1969-1 CB 45.
5. But see Let. Rul. 8628007.
6. See, e.g., Let Rul. 200903001.
7. IRC Sec. 104(a)(3); Rev. Rul. 55-331, 1955-1 CB 271, *modified by* Rev. Rul. 68-212, 1968-1 CB 91; Rev. Rul. 70-394, 1970-2 CB 34.

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104(a)(3) exclusion is not available where a taxpayer's claims for insurance benefits were not made in good faith and were not based on a true illness or injury.[1]

The accidental death benefit under a health insurance policy may be tax-exempt to a beneficiary as death proceeds of life insurance (Q 32).[2] Disability benefits received for loss of income or earning capacity under no fault insurance are excludable from gross income.[3] The exclusion also has been applied to an insured to whom policies were transferred by a professional service corporation in which the insured was the sole stockholder.[4]

Health insurance benefits are tax-exempt if received by the insured and if received by a person having an insurable interest in an insured.[5]

Medical expense reimbursement benefits must be taken into account in computing a taxpayer's medical expense deduction. Because only unreimbursed expenses are deductible, the total amount of medical expenses paid during a taxable year must be reduced by the total amount of reimbursements received in that taxable year.[6]

Likewise, if medical expenses are deducted in the year they are paid and then reimbursed in a later year, the taxpayer or the taxpayer's estate, where the deduction is taken on the decedent's final return but later reimbursed to the taxpayer's estate, must include the reimbursement, to the extent of the prior year's deduction, in gross income for the later year.[7]

Where the value of a decedent's right to reimbursement proceeds, which is income in respect of a decedent,[8] is included in the decedent's estate (Q 329), an income tax deduction is available for the portion of estate tax attributable to such value.

Disability income is not treated as reimbursement for medical expenses and, therefore, does not offset such expenses.[9]

> *Example*: Mr. Jones, whose adjusted gross income for 2012 was $25,000, paid $3,000 in medical expenses during that year. On his 2012 return, he took a medical expense deduction of $1,125 [$3,000 - $1,875 (7.5 percent of his adjusted gross income)]. In 2013, Mr. Jones receives the following benefits from his health insurance: disability income, $1,200; reimbursement for 2012 doctor and hospital bills, $400. He must report $400 as taxable income on his 2013 return. Had Mr. Jones received the reimbursement in 2012, his medical expense deduction for that year would have been limited to $725 ($3,000 - $400 [reimbursement] - $1,875 [7.5 percent of adjusted gross income]). Otherwise, he would have received the entire amount of insurance benefits, including the medical expense reimbursement, tax-free.

1. *Dodge v. Comm.*, 93-1 USTC ¶50,021 (8th Cir. 1992).
2. IRC Sec. 101(a); Treas. Reg. §1.101-1(a).
3. Rev. Rul. 73-155, 1973-1 CB 50.
4. Let. Rul. 7751104.
5. See IRC Sec. 104; *Castner Garage, Ltd. v. Comm.*, 43 BTA 1 (1940), acq. 1941-1 CB 11.
6. Rev. Rul. 56-18, 1956-1 CB 135.
7. Treas. Regs. §§1.104-1, 1.213-1(g); Rev. Rul. 78-292, 1978-2 CB 233.
8. See Rev. Rul. 78-292, above.
9. *Deming v. Comm.*, 9 TC 383 (1947), *acq.* 1948-1 CB 1.

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268. Can an existing life insurance policy be transferred between two trusts, both of which were established by the insured, without loss of the income tax exemption for death proceeds?

Sale to the insured is an exception to the transfer for value rule (Q 264).[1] The IRS recently ruled privately that a transfer between two trusts, one of which benefitted the taxpayer directly (Trust A) and the second of which was a grantor trust established by the taxpayer (as grantor) for the benefit of his children and grandchildren (Trust B), would not violate the transfer for value rule because the transaction fell within the exception permitting sale of a policy to the insured himself.[2]

While both trusts were irrevocable, the taxpayer retained the power to reacquire assets he had placed within Trust B by substituting assets of equal value. The independent trustee responsible for overseeing Trust B was required to ensure that any substituted assets were of equal value to the assets the taxpayer chose to reacquire.

Trust A owned a life insurance policy on the taxpayer's life, which the taxpayer wished to transfer into Trust B using his power of substitution. Because the taxpayer was both grantor of Trust B *and* the insured individual under the policy, the transaction was considered a transfer of the policy to the insured himself (the grantor and the grantor trust are treated as a single entity for tax purposes).

Therefore, even though the transfer was technically a transfer of the policy from one trust to another, it was considered to fall within the exception to the transfer for value rule permitting transfers to the insured himself.

Further, the value of the policy would not be included in the taxpayer's gross estate for estate tax purposes even though the taxpayer retained the right to move the policy between two irrevocable trusts. Typically, this type of power over an asset could cause the courts to find that a taxpayer retained incidents of ownership in an asset sufficient to warrant the asset's inclusion in the estate.

In this case, however, the taxpayer could never reduce the value of the assets in Trust B because he was required to substitute assets of equal value—and an independent trustee was present to verify equivalence. Additionally, the taxpayer could not increase his own net worth through a transfer because, again, the values of the substituted assets were required to be equal.

269. If an employer or an employer's qualified plan sells or distributes a policy on an employee's life to an insured's spouse or to another member of an insured's family, will the transfer cause loss of the tax exemption for the death proceeds?

Yes, generally, unless the transferee is a partner of the insured. This transfer does not come within any of the exceptions to the transfer for value rule (Q 264). If a sale is involved, death

1. IRC Sec. 101(a)(2)(B).
2. Let. Rul. 201235006.

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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 (Q 264).

A transfer to an insured, followed by a gift from the insured to the insured's spouse or family member (Q 265) or a sale to the insured's spouse after July 18, 1984 (Q 101) would avoid taxation of proceeds under the transfer for value rule. 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.[1]

270. Will a policyholder's sale of his or her life insurance policy to a corporation result in a loss of the tax exemption for the death proceeds?

No, if the insured is an officer or shareholder of the corporation. IRC Section 101(a)(2)(B) provides that the transfer for value rule does not apply if the transfer is to a corporation in which the insured is a shareholder or officer (Q 264). Moreover, where a policy is transferred more than once, but the last transfer is to a corporation in which the insured is an officer or shareholder, the proceeds will be wholly tax-exempt regardless of any previous sale or other transfer for value.[2]

Proceeds will lose their income tax-exempt status by sale to a corporation if an insured is merely a non-stockholder, non-officer employee, or director because this kind of sale does not come within the exceptions to the transfer for value rule (Q 264).

It also is doubtful whether a person who is only nominally an officer, with no real executive authority or duties, would be considered an officer.[3] Regulations do not define the term officer for this purpose.

It should be noted that the important relationship is that between an insured and a corporation. In other words, even though a policyholder is not an insured, the exception will apply provided the insured is an officer or shareholder in the corporation to which the policy is transferred.

Where an employer purchases a policy from an employee for contribution to a qualified plan, see Q 3865.

271. If a corporation sells or distributes a life insurance policy to a stockholder who is not the insured, will the transfer cause a loss of the tax exemption for the death proceeds?

No. The transfer of a policy to a corporation in which the insured is a shareholder can be made without loss of the tax exemption, even where the transferor is not the insured (Q 270).[4] The exception does not apply to a transfer in the reverse direction (Q 272).

1. *Est. of Rath v. U.S.*, 608 F2d 254 (6th Cir. 1979).
2. Treas. Reg. §1.101-1(b)(3)(ii).
3. See Rev. Rul. 80-314, 1980-2 CB 152.
4. IRC Sec. 101(a)(2)(B).

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272. Does a transfer for value problem arise when an insurance-funded stock redemption plan is changed to a cross-purchase plan, or vice versa?

If a corporation sells a policy on stockholder A's life to stockholder B, proceeds will lose their tax-exempt status (Q 271). Even if the corporation does not sell a policy, but merely distributes it to stockholders, there will be a transfer for value. Valuable consideration may be found, for example, in relieving the corporation of its obligation to continue premium payments and its obligation to redeem the stock or in satisfying the corporation's dividend obligation to its stockholders.[1] The danger cannot be averted by a transfer to the insured and a subsequent transfer by the insured to another stockholder (Q 273).

A transfer by a corporation to a shareholder was ruled to fall within an exception where stockholders also were partners in a bona fide, although unrelated, partnership.[2]

Similarly, a transfer of a reverse split dollar policy from a corporation to two shareholders who also were partners of the insured for the purpose of funding a cross purchase agreement fell within the partner exception to the transfer for value rule.[3]

Further, a transfer of policies insuring shareholders/partners from a corporation to a partnership established specifically to receive and manage the policies was considered within the partnership exception to the transfer for value rule.[4]

On the other hand, a change from a cross-purchase plan between individual stockholders to a stock redemption plan can be accomplished without violating the transfer for value rule. In each instance, a stockholder will be transferring a policy he or she owns on another stockholder's life to a corporation in which the insured is a shareholder. This kind of transfer qualifies as one of the exceptions to the transfer for value rule (Q 270).[5]

273. Will a transfer of a life insurance policy by one stockholder to another, or by a stockholder's estate to a surviving stockholder, cause loss of the tax exemption for the proceeds?

Yes, unless the person to whom the policy is transferred is the insured (Q 267) or unless the stockholders are also partners in a bona fide partnership (Q 274).

The exceptions to the transfer for value rule do not include transfers between individual stockholders (Q 271).[6] This is important to note in connection with an insurance funded buy-sell agreement on the cross-purchase plan where the plan involves more than two stockholders. After the first death, a survivor may wish to purchase a policy on the life of another survivor from the deceased's estate. This purchase would disqualify the death proceeds for income tax exemption.

1. See *Lambeth v. Comm.*, 38 BTA 351 (1938); *Monroe v. Patterson*, 197 F. Supp 146 (N.D. Ala. 1961).
2. Let. Rul. 9347016, Let. Rul. 9045004.
3. Let. Rul. 9701026.
4. Let. Rul. 9309021.
5. IRC Sec. 101(a)(2)(B).
6. IRC Sec. 101(a)(2).

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Moreover, suppose parties to a stock redemption plan wish to change to a cross-purchase plan and the corporation sells or distributes the policies to the insureds themselves. If the insureds then sell the policies to each other or exchange policies, the proceeds will lose their tax-exempt status. Even if no money is involved in the transaction, a valuable consideration can be found in the reciprocal transfers (Q 265).

To avoid transfer for value problems, some planners recommend that a policy owned by a shareholder on his or her own life be transferred to the corporation of which he or she is a shareholder. Then, subsequent to the transfer, the corporation enters into an endorsement split dollar agreement with an employee who desires to purchase the shares on the shareholder's death.

274. Is there a loss of the income tax exemption for death proceeds following a transfer of life insurance policies between partners, between partners and their partnership, to a partner of the insured, or to a partnership in which the insured is a partner?

No.

The transfer for value rule does not apply where a policy is transferred to a partner of the insured or to a partnership in which the insured is a partner.[1] The partnership actually must operate as a partnership, however, and not exist in form only.[2] A partner can sell a policy on his or her life to the partnership or to another partner. A retiring partner can sell to an incoming partner the policy the partner owns on another partner's life. A partnership can sell a policy to an insured partner or to a copartner of the insured. Where a partnership owns a key person policy on the life of a non-partner, there is no transfer for value when a new partner enters or an existing partner leaves the partnership, provided the partnership is not terminated by that action.[3]

Sale of a policy to a member of an insured's family who is not a partner would disqualify the proceeds for exemption. Where there is an insurance-funded buy-sell agreement between more than two partners and a partner dies, a surviving partner may buy policies on the lives of other surviving partners from the deceased's estate without loss of tax exemption for the death proceeds.[4]

The IRS has ruled in a private letter ruling that members of a limited liability company ("LLC"), which was classified as a partnership for federal tax purposes, would be considered partners for purposes of the transfer for value rule.[5]

A transfer for value by a corporation to a partnership in which an insured shareholder is a partner comes within the exception.[6] Similarly, a transfer to shareholders who are partners, even though in an unrelated partnership, falls within the exception.[7] Further, the IRS has ruled privately

1. IRC Sec. 101(a)(2)(B).
2. *Swanson v. Comm.*, 518 F.2d 59 (8th Cir. 1975), *aff'g* TC Memo 1974-61. But see Let. Rul. 9309021.
3. Let. Rul. 9410039.
4. See Let. Rul. 9727024.
5. Let. Rul. 9625013.
6. Let. Rul. 9042023.
7. Let. Rul. 9347016, Let. Rul. 9045004.

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that a transfer of policies insuring shareholders/partners from a corporation to a partnership established specifically to receive and manage the policies comes within the exception.[1]

A sale of policies by an insured's grantor trust to a limited partnership where the insured was a limited partner was ruled within the exemption.[2]

The IRS has indicated, however, that it will not issue rulings concerning whether or not the exception applies to a transfer of a life insurance policy to an unincorporated organization where substantially all of the organization's assets consist or will consist of life insurance policies on the lives of its members.[3]

If a policy is transferred more than once and the last transfer, or the last transfer for value, is to a partner of the insured or to a partnership in which the insured is a partner, proceeds will be entirely tax-exempt regardless of any previous transfer for value.[4]

275. Is there a loss of the tax exemption for death proceeds after a life insurance policy is transferred to a corporation in a tax-free organization or reorganization?

No, if the insured is an officer or shareholder in the corporation to which the policy is transferred (Q 270).

Moreover, even where an insured is not an officer or shareholder of a transferee corporation, proceeds will not lose their tax-exempt status if a policy is transferred as part of a general tax-free transfer. For example, a transfer of property in organizing a corporation is tax-free if immediately after the transfer the persons who exchanged property for stock own at least 80 percent of the voting stock and 80 percent of all other classes of stock in the corporation. This kind of transfer usually takes place, for example, when an unincorporated business is incorporated.

Other examples of tax-free transfers include tax-free reorganizations, which include statutory mergers, consolidations and the transfers of substantially all the property of one corporation solely in exchange for the voting stock of another corporation.[5] Where an asset changes hands in a tax-free transfer, the tax basis of the asset does not change.[6] Consequently, such a transfer comes within the exception to the transfer for value rule set forth in IRC Section 101(a)(2)(A) (Q 264).

If proceeds would not have been exempt had a policy been retained by a transferor, the tax-free transfer will not cause them to become tax-exempt unless the insured is an officer or shareholder of the transferee corporation.[7]

1. Let. Rul. 9309021.
2. Let. Rul. 9843024.
3. Rev. Proc. 2006-3, 2006-1 IRB 122; Rev. Proc. 2014-3, 2014-1 IRB 111.
4. Treas. Reg. §1.101-1(b)(3)(ii).
5. IRC Sec. 368.
6. IRC Sec. 358.
7. Treas. Reg. §1.101-1(b)(3).

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If a corporation purchases the assets of another corporation in a transaction that is not a tax-free reorganization and those assets include a life insurance policy, the sale will cause a loss of exemption for the proceeds unless the insured is an officer or shareholder of the purchasing corporation (Q 270).[1]

Proceeds Taxable as Dividends or Compensation

276. When are death proceeds of life insurance taxable as dividends or compensation?

Proceeds that have been received tax-free by a C corporation lose their tax-exempt character as life insurance proceeds on distribution to employees or shareholders. Consequently, where a corporation is both owner and beneficiary of a policy, the proceeds generally will be tax-free to the corporation (but see Q 263). If the corporation distributes the proceeds to its shareholders, however, the shareholders will be treated as having received a taxable dividend.[2]

If an insured is an employee and proceeds are received by a corporation and then paid to the employee's widow or other personal beneficiary under the terms of an employment contract, they may be treated as taxable compensation for the employee's past services.[3]

On the other hand, if a corporation has no ownership rights in a policy and is not the beneficiary, proceeds should be received tax–free by the beneficiary as life insurance proceeds (Q 62, Q 64).[4] Where a corporation paid the premiums on a policy that was held by a trustee for the benefit of certain shareholders and the corporation had no ownership rights in the policy, the court held the proceeds received by the shareholders were tax-exempt life insurance proceeds.[5] The IRS has indicated, however, that the premiums when paid by a corporation may, in some circumstances, be taxed to shareholders as dividends (Q 252).[6]

Where a corporation owns a policy and is not the beneficiary, it appears that the proceeds are taxable as dividends and possibly as compensation. Where the proceeds of a policy were payable to a trustee for the benefit of shareholders but the corporation had substantial ownership rights in the policy, the court conceded that the proceeds were life insurance proceeds but said that they also were in the nature of dividends and under such circumstances, the dividend provisions of the tax law would prevail.[7]

The U.S. Court of Appeals for the Sixth Circuit reached an opposite conclusion in the *Ducros* case. There, a policy was owned by a corporation and individual stockholders were named as revocable beneficiaries in the policy. The court held that the proceeds received by shareholders directly from the insurance company were life insurance proceeds and, therefore, tax-exempt.[8]

1. IRC Sec. 101(a)(2)(B); *Spokane Dry Goods Co. v. Comm.*, 1 TCM (CCH) 921 (1943)
2. Rev. Rul. 71-79, 1971-1 CB 112.
3. *Essenfeld v. Comm.*, 311 F2d 208 (2d Cir. 1962).
4. IRC Sec. 101(a).
5. *Doran v. Comm.*, 246 F.2d 934 (9th Cir. 1957).
6. Rev. Rul. 59-184, 1959-1 CB 65.
7. *Golden v. Comm.*, 113 F.2d 590 (3rd Cir. 1940).
8. *Ducros v. Comm.*, 272 F.2d 49 (6th Cir. 1959).

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The IRS has announced its refusal to follow *Ducros* as precedent in disposing of similar cases.[1] Revenue Ruling 61-134 states that it is the position of the IRS "that life insurance proceeds paid to stockholders of a corporation are taxable as dividends in cases where the corporation uses its earnings to pay the insurance premiums and has all incidents of ownership including the right to name itself beneficiary, even though the corporation does not name itself beneficiary and, therefore, is not entitled to and does not in fact receive the proceeds."

The same principle should apply if proceeds of a corporate owned policy are payable directly to an insured employee's beneficiary, although the proceeds ordinarily would be taxable compensation rather than dividends. Nonetheless, a Technical Advice Memorandum has held that proceeds of a corporate owned and paid for life insurance policy naming as revocable beneficiary the wife of the insured-stockholder were not dividends because she was not a stockholder and the estate-stockholder was not a beneficiary. The proceeds were not income in respect of a decedent, but rather were life insurance death proceeds tax-free under IRC Section 101(a).[2]

Assuming, but not deciding on, the validity of Estate Tax Regulation Section 20.2042-1(c)(6) (Q 302), the Tax Court has held that where a corporation owned insurance on the life of a controlling stockholder and where the beneficiary named by the corporation was the insured's wife, who owned stock in the corporation, death proceeds were not taxable to the beneficiary as a dividend but were excludable from her income as proceeds of life insurance under IRC Section 101(a)(1).[3]

In the case of an S corporation, each shareholder increases his or her basis in his or her stock by his or her share of the tax-free death proceeds received by the corporation. In the event a closing of the books election is made under IRC Section 1377(a)(2) for a cash basis S corporation, the basis increase will be allocated to the surviving shareholders rather than apportioning some of the basis increase to the decedent's shares. Thereafter, any distribution of proceeds should be determined to be compensation or a distribution with respect to stock as if it were a regular C corporation (Q 279).

Where insurance is used to fund a stock redemption agreement, see Q 292.

Proceeds Taxable Because of Lack of Insurable Interest

277. If a corporation takes out a life insurance policy on a person in whose life the corporation has no insurable interest, will death proceeds be exempt from income tax?

There is danger that proceeds may be considered taxable income from a wagering contract instead of tax-exempt life insurance proceeds.[4] If there is an insurable interest when a policy is taken out, the contract will not be considered a wagering contract, even if an insurable interest

1. Rev. Rul. 61-134, 1961-2 CB 250.
2. TAM 8144001.
3. *Est. of Horne v. Comm.*, 64 TC 1020 (1975), acq. in result, 1980-1 CB 1.
4. *Atlantic Oil Co. v. Patterson*, 331 F2d 516 (5th Cir. 1964).

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is not present at death.[1] Insurable interest is determined by the laws of the various states. Consequently, if there is an insurable interest under applicable state law, death proceeds should qualify as life insurance proceeds under IRC Section 101(a).

Proceeds as Restitution of Embezzled Funds

278. Where a life insurance policy is assigned to an employer in restitution of funds embezzled by an insured, are proceeds tax-exempt to the employer?

No.

The employer does not receive the proceeds as life insurance payable by reason of the insured's death but as a restitution of embezzled funds. Consequently, the income tax exclusion under IRC Section 101(a) does not apply. If the employer has claimed a loss deduction, the employer must report the proceeds as a recovery of a previously deducted embezzlement loss.[2]

S Corporations

279. What are the tax consequences for death proceeds of a life insurance policy purchased by an S corporation?

Where an S corporation is beneficiary of a policy and death proceeds are received as tax-exempt income, each stockholder's pro rata share of the proceeds is tax-exempt to him or her and the basis of each stockholder's stock is increased by his or her share of the tax-exempt proceeds.[3] An S corporation's delay in receiving death proceeds that will be used to purchase a deceased shareholder's shares still will result in an increase in the basis of all the shareholder's shares, not just the shares of the surviving shareholders.[4]

Planning Point: There are special notice, consent, and reporting requirements applicable to employer owned policies entered into after August 17, 2006 (Q 263). If these requirements are not met, a portion of the death benefit becomes taxable income.

If a corporation is neither owner nor beneficiary, proceeds of a policy paid for by the corporation should be tax-free to the beneficiary as life insurance proceeds (Q 62 to Q 74). The transfer for value rule has an impact on the taxation of death proceeds (Q 264). If a corporation owns a policy but is not the beneficiary, the characterization of the proceeds is not entirely clear (Q 276). If they are treated as a distribution of profits, that is, as dividends in the case of a regular C corporation, they would be taxed as a return of basis, capital gain, or dividends. If proceeds paid to a beneficiary of a policy owned by a corporation are treated as corporate distributions, they also should be treated as tax-free proceeds to the corporation that increase each shareholder's basis pro rata.

1. *Ducros v. Comm.*, 272 F.2d 49 (6th Cir. 1959).
2. *Tennessee Foundry & Mach. Co. v. Comm.*, 399 F2d 156 (6th Cir. 1968).
3. IRC Secs. 1366(a)(1)(A), 1367(a)(1)(A).
4. Let. Rul. 200409010.

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Transfer of Policy

280. If an employer owns a policy on the life of an employee and sells the policy to the employee for its cash surrender value, can the sale result in taxable income to the employee or to the employer?

Transfers of property after June 30, 1969, in connection with the performance of services are governed by IRC Section 83. Effective for transfers after February 12, 2004, regulations under IRC Section 83 provide that, "In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property."

For a policy which is part of a split dollar arrangement entered into on or before September 17, 2003, and which is not materially modified after that date, only the cash surrender value is considered "property."[1] Therefore, if a policy's actual value was more than the cash surrender value, then a sale may result in taxable income to an employee.

Under prior regulations where only the cash surrender value was considered property, the IRS concluded that where full ownership of a life insurance policy was transferred from an employer corporation to a key person, IRC Section 83 required that the employee include as income a policy's cash surrender value, less any payments the employee made for the policy.[2]

If a policy is sold by an employer for its cash surrender value, which is less than the total premiums paid, the employer can exclude from gross income the amount received from the sale of the insurance policy to the employee.[3] No loss deduction is allowable, however, when total premiums paid exceed the sale price (Q 61).

If a policy is sold by an employer for the cash surrender value, which exceeds the employer's basis in the contract, the amount realized by the employer in excess of basis is taxable income to the employer.

281. If an employee or stockholder sells a life insurance policy to the corporation for its cash surrender value, does the employee or stockholder realize a taxable gain?

Yes, if the cash surrender value is greater than the employee or stockholder's net premium cost. The gain is ordinary income, not capital gain.[4] Normally, there is no deductible loss where a policy is sold for its cash surrender value (Q 61). If a policy sold is subject to a nonrecourse loan, the amount realized on the sale includes the amount of the loan (Q 265).[5]

1. Treas. Reg. §1.83-3(e).
2. Let. Rul. 8905010.
3. Rev. Rul. 70-38, 1970-1 CB 11.
4. *Gallun v. Comm.*, 327 F2d 809 (7th Cir. 1964).
5. Treas. Reg. §1.1001-2(a).

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282. What are the income tax consequences when a corporation transfers a life insurance policy to an employee or stockholder without consideration?

When a corporation transfers a life insurance policy to an employee or stockholder without consideration, the entire value of the policy is taxable to the employee or stockholder as compensation or as a dividend. For the value of a policy that has not yet matured, see Q 139.

Where a transferee is a stockholder-employee, the circumstances of a distribution will determine whether it is compensation or dividend. *Thornley v. Comm.*[1] dealt with insurance on the lives of two stockholders that was purchased by a corporation to fund a stock redemption agreement. The agreement provided that on the first death, policies on the survivor's life were to be distributed to the survivor without cost. The Tax Court held that the value of the un-matured policies was taxable as a dividend to the survivor in the year the other stockholder died.

In another Tax Court case, the value of a life insurance policy constituted long-term capital gain to an officer-stockholder who received the policy in exchange for his stock in the corporation.[2]

In a similar case, however, capital gains treatment was denied where there was no proof that a policy was received as part of the redemption price of stock.[3]

If an employee's rights are subject to a substantial risk of forfeiture (Q 3530), the full value of the policy is not taxable until the employee's rights become substantially vested. The net premium cost of life insurance protection is taxable to the employee during the period the contract remains substantially non-vested.[4]

If an employee takes a policy subject to a nonrecourse loan, the employee has given consideration to the extent of the loan amount (Q 265).

To the extent there is gain in a policy, an employer's transfer of the policy to the employer or a stockholder triggers taxable income to the employer, similar to the sale of the policy (Q 280).

If a transfer is to someone other than an insured, the transfer for value rule should be considered.

Stock Purchase Agreement

283. Will sale of a deceased's stock under a cross-purchase insurance-funded buy-sell agreement result in income tax liability to the deceased's estate?

There normally will be no taxable gain to a deceased's estate if stock is sold to surviving individual shareholders at its full market value under a standard buy-sell agreement. At the stockholder's death, the stockholder's stock receives a new tax basis equal to its fair market

1. 41 TC 145 (1963).
2. *Parsons v. Comm.*, 54 TC 54 (1970).
3. *Wilkin v. Comm.*, TC Memo 1969-130.
4. Treas. Reg. §1.83-1(a)(2).

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value at the time of death or an alternate valuation date.[1] Because the sale price under a properly designed buy-sell agreement usually is accepted as the fair market value of the stock, the basis and sale price normally will be the same (Q 305). Consequently, there should be no capital gain. Since individuals, rather than the corporation, purchase the stock, the payment cannot be regarded as a dividend (Q 285).

284. What are the income tax consequences of funding a stock purchase agreement with life insurance?

Premiums

Regardless of whether a stockholder pays premiums on a policy on the life of another stockholder or on a policy on the stockholder's own life to fund an agreement, the stockholder cannot deduct premium payments (Q 249).[2]

If stockholders attempt to use company-paid group term life insurance to fund their buy-sell agreement, the company may be denied a deduction for its premium payments. The IRS has held, in a private ruling, that premium payments under these circumstances are not related to a corporation's trade or business.[3] Moreover, if stockholders reciprocally name each other as beneficiaries of their insurance or reciprocally agree to apply proceeds to the purchase of their stock, the proceeds may be taxable under the transfer for value rule (Q 265).

Premiums paid by an insured's associate stockholders are not taxable income to the insured. If a corporation pays premiums on insurance to fund a buy-sell agreement between individual stockholders, premium payments will be taxable dividends to those stockholders (Q 254).[4] If an S corporation pays premiums, see Q 256.

Death Proceeds

Provided the parties have not violated the transfer for value rule, death proceeds are received free of income tax by surviving stockholders (Q 263).[5] Each survivor applies the tax-free proceeds received to purchase stock from a deceased's estate.

Cost Basis

The amount a survivor pays an estate for stock becomes the survivor's cost basis in the stock. This cost basis will be used to calculate the survivor's gain or loss should the survivor dispose of the stock during the survivor's lifetime. If a survivor holds stock until death, the estate will receive a stepped-up basis in the stock. An exception existed for decedents dying in 2010 under a modified carryover basis system that was put into place for that year only.

1. See IRC Sec. 1014.
2. IRC Secs. 262, 264(a)(1).
3. Let. Rul. 6206295970A.
4. *Doran v. Comm.*, 246 F.2d 934 (9th Cir. 1957); *Paramount-Richards Theatres, Inc. v. Comm.*, 153 F.2d 602 (5th Cir. 1946); see also Rev. Rul. 59-184, 1959-1 CB 65.
5. IRC Sec. 101(a).

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A cross-purchase agreement commonly gives each survivor a right to purchase from the deceased's estate the un-matured policy on the survivor's own life. If an agreement calls for transfer of a policy without cost to an insured, it would seem that the insured's cost basis for the stock should be reduced by the value of the policy. The Sixth Circuit Court of Appeals has held otherwise.[1]

After the first death, continued use of policies to fund a buy-sell agreement between survivors will bring adverse tax results under the transfer for value rule (Q 273).

Planning Point: Compared to a stock redemption agreement, use of a cross-purchase agreement between stockholders provides flexibility to convert to a stock redemption agreement using the same life insurance policies, which (Q 272) provides the surviving stockholders with an increased cost basis (Q 283), avoids increasing the estate tax value of the decedent's estate (Q 284), avoids application of family attribution rules (Q 285), and does not expose death benefits to the alternative minimum tax (Q 300).

With multiple stockholders, the number of policies required to fund the cross-purchase agreement can be reduced by using a trusteed cross-purchase agreement or a cross-endorsement arrangement and having the trustee, as escrow agent, own a life insurance policy on each stockholder. *Donald F. Cady, J.D., LL.M., CLU.*

285. If a corporation redeems all of its stock owned by a deceased stockholder's estate, will the amount paid by the corporation be taxed as a dividend distribution to the estate?

As a general rule, any payment by a corporation other than an S corporation to a shareholder will be treated as a dividend rather than a capital transaction even if the payment is made to redeem stock.[2]

If a payment is treated as a dividend, the entire amount paid to an individual generally will be taxed at 15 percent, with no deduction for basis, and earnings and profits of the corporation will be reduced by the amount of money or other property distributed by the corporation.[3] Under the American Taxpayer Relief Act of 2012 ("ATRA"), the maximum dividend rate was increased to 20 percent for taxpayers who fall within the new 39.6 percent income tax bracket (i.e., individual taxpayers earning over $400,000 annually and married taxpayers filing jointly who earn over $450,000 annually, as adjusted for inflation. The amounts for 2014 are $406,750 and $457,600).[4]

There are several exceptions, discussed below, to the general rule that allow a payment to be treated as a sale or exchange. If a payment is characterized as a sale or exchange, it will be taxed as a capital gain.

In the context of closely held corporations, the characterization of a stock redemption is important for at least two additional reasons.

1. *Storey v. U.S.*, 305 F 2d 733 (6th Cir. 1962).
2. IRC Sec. 301(a); Rev. Rul. 55-515, 1955-2 CB 222.
3. IRC Secs. 312(a), 316(a).
4. American Taxpayer Relief Act of 2012, Public Law No. 112-240, Sec. 102.

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First, if a redemption is treated as a sale or exchange, the basis of the shares retained by the seller, if any, is unaffected by the transaction. If a redemption is treated as a dividend, the basis of the shares redeemed is added to the basis of the shares retained.[1]

Second, if a redemption is treated as a sale or exchange, the part of the distribution properly chargeable to earnings and profits is an amount not in excess of the ratable share of earnings and profits of the corporation attributable to the redeemed stock.[2] If a redemption is treated as a dividend, earnings and profits of the corporation are reduced by the amount of money or other property distributed by the corporation.[3]

One of the exceptions to dividend treatment mentioned above is contained in IRC Section 302(b)(3). IRC Section 302(b)(3) provides that if a corporation redeems all of a shareholder's remaining shares so that a shareholder's interest in the corporation is terminated, the amount paid by the corporation will be treated as a payment in exchange for the stock, not as a dividend. In other words, the redemption will be treated as a capital transaction (Q 290).[4]

There will be no taxable dividend, then, if a corporation redeems all of its stock owned by an estate. In determining what stock is owned by an estate, the constructive ownership or attribution-of-ownership rules contained in IRC Section 318 must be applied.

Consequently, to achieve non-dividend treatment under IRC Section 302(b)(3), a corporation must redeem not only all of its shares actually owned by an estate, but also all of its shares constructively owned by the estate.

One of these constructive ownership rules provides that shares owned by a beneficiary of an estate are considered owned by the estate. For example, assume that a decedent owned 250 shares of Corporation X's stock, so that the decedent's estate now actually owns 250 shares. Assume further that a beneficiary of the decedent's estate owns 50 shares. Because the estate constructively owns the beneficiary's 50 shares, the estate is deemed to own a total of 300 shares. Redemption of the 250 shares actually owned, therefore, will not affect a redemption of all the stock owned by the estate.

Furthermore, stock owned by a close family member of a beneficiary of an estate may be attributed to an estate beneficiary, because of the family constructive ownership rules, and through the estate beneficiary to the estate. An estate beneficiary would be considered to own, by way of family attribution rules, shares owned by the decedent's spouse, children, grandchildren, and parents.[5]

It has been held that where, because of hostility among family members, a redeeming shareholder is prevented from exercising control over stock that the individual would be deemed

1. Treas. Reg. §1.302-2(c).
2. IRC Sec. 312(n)(7).
3. IRC Secs. 312(a), 316(a).
4. Rev. Rul. 77-455, 1977-2 CB 93.
5. IRC Sec. 318(a).

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to own constructively under attribution rules, the attribution rules will not be applied to the individual.[1]

On the other hand, the IRS has indicated it will not follow that decision and has ruled that the existence of family hostility will not affect its application of attribution rules.

If certain conditions are met, however, the IRS will not apply the ruling to taxpayers who have acted in reliance on the IRS's previously announced position on this issue.[2] The Fifth Circuit also has taken the position that the existence of family hostility does not prevent application of attribution rules, thus creating disagreement between the two circuit courts that have ruled on the question.[3] The Tax Court consistently has held that hostility within a family does not affect application of attribution rules.[4]

Constructive ownership rules are complicated and their application requires expert legal advice. It generally may be said that a danger of dividend tax treatment exists in every case involving a family-owned corporation engaging in a stock redemption. There are, however, means available in some cases to avoid the harsh operation of the rules (Q 286, Q 287). A partial redemption may be able to escape dividend tax treatment even in a family-owned corporation (Q 288).

286. How can attribution of stock ownership among family members be avoided?

In attempting to qualify under the complete redemption rules (Q 285), the adverse effect of family attribution rules, that is, the rules that attribute stock ownership between family members as distinct from other attribution rules that attribute stock ownership from or to estates, trusts, or business entities, ordinarily may be overcome if a shareholder from whom stock is redeemed:

(1) retains no interest in the corporation except as a creditor immediately after redemption;

(2) does not acquire any such interest other than stock acquired by bequest or inheritance within ten years after the date of the redemption; and

(3) files an agreement, called a waiver agreement, to notify the IRS of a redeeming shareholder's acquisition of a forbidden interest within the ten year period.[5]

With respect to distributions after August 31, 1982, an entity such as a trust or estate that terminates its interest may waive family attribution rules as long as the related party, that is, a beneficiary, stockholder, or partner through whom ownership of stock is attributed to the entity, joins in the waiver. The language of the IRC prohibits waiver of entity attribution.[6]

1. *Robin Haft Trust v. Comm.*, 510 F.2d 43(1st Ciir. 1975).
2. Rev. Rul. 80-26, 1980-1 CB 66; IRC Sec. 7805(b).
3. *David Metzger Trust v. Comm.*, 693 F2d 459 (5th Cir. 1982), *cert. den.*, 463 U.S. 1207 (1983).
4. See *Cerone v. Comm.*, 87 TC 1 (1986).
5. IRC Sec. 302(c)(2)(A). As for what constitutes a forbidden retained interest, see *Lynch v. Comm.*, 801 F2d 1176 (9th Cir. 1986); *Cerone v. Comm.*, 87 TC 1 (1986); *Seda v. Comm.*, 82 TC 484 (1984); *Est. of Lennard*, 61 TC 554 (1974), *acq. in result*, 1974-2 CB 3; Rev. Rul. 70-104, 1970-1 CB 66; Rev. Rul. 71-426, 1971-2 CB 173; Rev. Rul. 71-562, 1971-2 CB 173; Rev. Rul. 84-135, 1984-2 CB 80.
6. IRC Sec. 302(c)(2)(C).

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Family attribution rules will not be waived (1) if any portion of redeemed stock was acquired, directly or indirectly, by a redeeming shareholder within ten years before redemption from any member of the shareholder's family named in the family attribution rules, or (2) if any member of a redeeming shareholder's family named in the family attribution rules owns stock in the corporation at the time of the redemption and the person acquired any stock in the corporation from the redeeming shareholder within ten years before the redemption, unless the acquired stock is redeemed in the same transaction.

The foregoing limit does not apply if an acquisition (as in (1)) or a disposition (as in (2)) by a redeeming shareholder did not have as one of its principal purposes avoidance of federal income tax.[1]

One ruling illustrates the application of this limit on the limitation. A son and his father's estate owned all the outstanding stock of X corporation. The son's mother was the sole beneficiary of the estate. The son was active in the business; his mother was not. After the executor distributed the stock to the mother, X corporation redeemed all the mother's stock so that the son could have complete ownership of X corporation. The mother's waiver agreement was effective to prevent the attribution to her of her son's stock, even though she had acquired the redeemed stock indirectly from her husband within 10 years of the redemption, because her acquisition of the stock did not have as one of its principal purposes the avoidance of federal income tax.[2]

287. Can an executor avoid attribution of stock ownership from an estate beneficiary to the estate by distributing the beneficiary's legacy before the redemption of the estate-held stock?

As a relief provision, regulations state that, "A person shall no longer be considered a beneficiary of an estate when all the property to which he is entitled has been received by him, when he no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property or to seek payment from him by contribution or otherwise to satisfy claims against the estate or expenses of administration."[3]

Thus, estate-beneficiary constructive ownership rules can be avoided, in some instances, by distributing a beneficiary-shareholder's legacy to the beneficiary-shareholder before redemption takes place. Many states have apportionment laws calling for allocation of estate taxes among estate beneficiaries in all cases where a decedent did not direct otherwise by will.

If distribution of a legacy to a beneficiary-shareholder in one of those states occurs before payment of estate taxes or without deduction for a beneficiary's share of the taxes, the shareholder still will be considered a beneficiary of the estate within the meaning of the regulation even after the distribution.[4]

1. IRC Sec. 302(c)(2)(B).
2. Rev. Rul. 79-67, 1979-1 CB 128.
3. Treas. Reg. §1.318-3(a).
4. *Est. of Webber v. U.S.,404 F2d 411*, 22 AFTR 2d 5911 (6th Cir. 1968).

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Moreover, even if a shareholder's legacy has been distributed to the shareholder and he or she no longer has any claim against the estate, or the estate against the shareholder, if a member of the shareholder's family remains a beneficiary of the estate, the shareholder's shares may be attributed to the estate through the family member.[1]

The relief provision under Treasury Regulation Section 1.318-3(a) is not available if a residuary legatee of an estate owns stock, because a residuary legatee's interest in the estate does not cease until the estate is closed.[2]

Moreover, if a trust is a beneficiary of an estate and a surviving shareholder is a beneficiary of the trust, the surviving shareholder's stock will be attributed to the trust and through the trust to the estate.[3]

288. What is a Section 303 stock redemption?

Estates of decedents comprised largely of close corporation stock commonly have a liquidity problem. Congress enacted IRC Section 303 expressly to aid these estates in solving this problem and to protect small businesses from forced liquidations or mergers due to the heavy impact of death taxes. Within the limits of IRC Section 303, surplus can be withdrawn from the corporation free of income tax.

In certain instances, stock of a public corporation also may be redeemed under IRC Section 303.

Any payments by a corporation to a shareholder generally are treated as dividends (Q 285). IRC Section 303 provides that, under stipulated conditions (see Q 289), a corporation can redeem part of a deceased stockholder's shares without the redemption being treated as a dividend. Instead, the redemption price will be treated as payment in exchange for the stock as a capital transaction (Q 290). An IRC Section 303 redemption can safely be used in connection with the stock of a family-owned corporation because constructive ownership rules are not applied in an IRC Section 303 redemption (Q 285).[4]

The stock of any corporation, including an S corporation, may qualify for an IRC Section 303 redemption. Moreover, any class of stock may be redeemed under IRC Section 303. Thus, a nonvoting stock, common or preferred, issued as a stock dividend or issued in a lifetime or post-death recapitalization can qualify for the redemption.[5]

Where a corporation issued nonvoting shares immediately prior to and as a part of the same transaction as the redemption, a valid IRC Section 303 redemption was made.[6]

1. IRC Sec. 318(a)(5)(A).
2. Rev. Rul. 60-18, 1960-1 CB 145.
3. Rev. Rul. 67-24, 1967-1 CB 75; Rev. Rul. 71-261, 1971-1 CB 108.
4. IRC Secs. 318(a) and 318(b)
5. Treas. Reg. §1.303-2(d).
6. Rev. Rul. 87-132, 1987-2 CB 82.

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IRC Section 306 stock is preferred stock distributed to shareholders as a stock dividend, the sale or redemption of which may subject the proceeds to income tax treatment as dividend income because of special rules contained in IRC Section 306. A distribution in redemption of IRC Section 306 stock will qualify under IRC Section 303 to the extent the conditions of IRC Section 303 are met.[1]

289. What conditions must be met for a stock redemption to qualify as a Section 303 stock redemption and thus obtain non-dividend treatment?

The following conditions must be met if a stock redemption is to qualify under IRC Section 303 for non-dividend treatment:

(1) The stock that is to be redeemed must be includable in the decedent's gross estate for federal estate tax purposes.

(2) The value for federal estate tax purposes of all stock of a redeeming corporation that is includable in a decedent's gross estate must comprise more than 35 percent of the value of the decedent's adjusted gross estate.[2] The "adjusted gross estate" for this purpose is the gross estate less deductions for estate expenses, indebtedness and taxes[3] and for unreimbursed casualty and theft losses.[4] The total value of all classes of stock includable in a gross estate is taken into account to determine whether this 35 percent test is met, regardless of which class of stock is to be redeemed.[5]

IRC Section 303(b) provides that a corporate distribution in redemption of stock will qualify as an IRC Section 303 redemption if all the stock of the corporation that is included in determining the value of a gross estate exceeds 35 percent of the adjusted gross estate. Although most gifts made by a donor within three years of the donor's death are not brought back into the donor's gross estate under IRC Section 2035, certain kinds of gifts are brought back. These are described in Q 698 in the "first kind of exception" gifts. Gifts of corporation stock that fall within this classification are part of a gross estate for purposes of computing the 35 percent requirement (or the 20 percent requirement discussed below) and a corporation's redemption of this stock will qualify as a sale or exchange if all other requirements of IRC Section 303 are satisfied. IRC Section 2035(c)(1)(A) states generally that the three year rule will apply for the purposes of IRC Section 303(b). The Treasury and the IRS interpret the foregoing as follows: If a decedent makes a gift of any kind of property within three years of his or her death, the value of the property given will be included in the decedent's gross estate for purposes of determining whether the value of the corporation stock in question exceeds 35 percent of the value of the gross estate, but a distribution in redemption of that stock will not qualify as

1. Treas. Reg. §1.303-2(d).
2. IRC Sec. 303(b)(2)(A).
3. IRC Sec. 2053.
4. IRC Sec. 2054.
5. Treas. Reg. §1.303-2(c)(1).

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an IRC Section 303 redemption unless the stock redeemed actually is a part of the decedent's gross estate.[1]

The stock of two or more corporations will be treated as that of a single corporation, provided that 20 percent or more of the value of all of the outstanding stock of each corporation is includable in a decedent's gross estate.[2] Only stock directly owned is taken into account in determining whether the 20 percent test has been met; constructive ownership rules do not apply even when they would benefit a taxpayer.[3] Stock that, at a decedent's death, represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common is considered to be includable in a decedent's gross estate for the purpose of meeting the 20 percent requirement.[4] The 20 percent test is not an elective provision; that is, if a distribution in redemption of stock qualifies under IRC Section 303 only by reason of the application of the 20 percent test and also qualifies for sale treatment under another section of the IRC, the executor may not elect to have only the latter section of the IRC apply and thus retain undiminished the IRC Section 303 limits for later use. All distributions that qualify under IRC Section 303 are treated as IRC Section 303 redemptions in the order they are made.[5]

(3) The dollar amount that can be paid out by a corporation under protection of IRC Section 303 is limited to an amount equal to the sum of (x) all estate taxes, including the generation-skipping transfer tax imposed by reason of the decedent's death, and federal and state inheritance taxes attributable to a decedent's death, plus interest, if any, collected on these taxes, and (y) funeral and administration expenses allowable as estate deductions under IRC Section 2053.[6]

(4) The stock must be redeemed not later than (x) three years and ninety days after the estate tax return is filed, which return must be filed within nine months after a decedent's death, (y) sixty days after a Tax Court decision on an estate tax deficiency becomes final, or (z) if an extension of time for payment of tax is elected under IRC Section 6166, the time determined under the applicable section for payment of the installments. For any redemption made more than four years after a decedent's death, however, capital gains treatment is available only for a distribution in an amount that is the lesser of the amount of the qualifying death taxes and funeral and administration expenses that are unpaid immediately before the distribution, or the aggregate of these amounts that are paid within one year after the distribution.[7]

1. Rev. Rul. 84-76, 1984-1 CB 91.
2. IRC Sec. 303(b)(2)(B).
3. *Est. of Byrd v. Comm.*, 388 F2d 223, 21 AFTR 2d 313 (5th Cir. 1967).
4. IRC Sec. 303(b)(2)(B).
5. Treas. Reg. §1.303-2(g); Rev. Rul. 79-401, 1979-2 CB 128.
6. IRC Secs. 303(a), 303(d).
7. IRC Secs. 303(b)(1), 303(b)(4).

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(5) The shareholder from whom stock is redeemed must be one whose interest is reduced directly, or through a binding obligation to contribute, by payment of qualifying death taxes and funeral and administration expenses, and the redemption will qualify for capital gains treatment only to the extent of that reduction.[1] That is, "the party whose shares are redeemed [must actually have] a liability for estate taxes, state death taxes, or funeral and administration expenses in an amount at least equal to the amount of the redemption."[2]

290. Does redemption under an insurance-funded stock redemption agreement result in capital gain to a deceased stockholder's estate?

No. An estate typically realizes no capital gain as a result of a redemption. Where a redemption is a capital transaction (Q 285 to Q 288), an estate has no tax liability unless the price paid by the corporation exceeds the new tax basis of the stock redeemed.

When a stockholder dies, his or her stock receives a new basis equal to its fair market value at date of death or at an alternate valuation date.[3]

As sale price under a proper stock redemption agreement generally is accepted as the fair market value of shares (Q 305), the sale price should equal the estate's basis and no gain or loss should be realized by an estate.

For decedents dying in 2010, modified carryover basis rules in IRC Section 1022 may apply, so stock may not receive a full basis step-up.

291. If a close corporation redeems stock from a decedent's estate, is the amount paid for the stock taxable as a constructive dividend to the surviving stockholder or stockholders?

No.

A surviving stockholder will not be treated as having received a constructive dividend merely because the percentage of his or her interest in a corporation is increased by a redemption.[4] A redemption may result in a constructive dividend to a survivor if the survivor had an obligation to purchase the stock, for example, under a cross-purchase agreement, and redemption by the corporation satisfies that personal obligation.[5]

A survivor does not realize taxable income from a redemption unless his or her obligation to purchase stock was primary and unconditional. Thus, there is no constructive dividend if a survivor has assigned his or her obligation to the corporation before conditions for performance of

1. IRC Sec. 303(b)(3).
2. H.R. Rep. No. 94-1380 at 35 (Estate and Gift Tax Reform Act of 1976), reprinted in 1976-3 CB (Vol. 3) 735 at 769.
3. IRC Secs. 1014(a)(1), 1014(a)(2).
4. *Holsey v. Comm.*, 258 F.2d 865 (3rd Cir. 1958); Rev. Rul. 58-614, 1958-2 CB 920; Rev. Rul. 59-286, 1959-2 CB 103.
5. *Smith v. Comm.*, 70 TC 651 (1978).

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the contract arose, if the buyout contract contained a provision permitting the stockholder to call on the corporation to buy the stock, or if the survivor could have elected not to buy the stock.[1]

292. What are the income tax consequences of funding a stock redemption agreement with life insurance?

Premiums

The IRS does not consider premiums paid by a corporation under a stock redemption agreement to be ordinary and necessary business expenses. Furthermore, regardless of whether a corporation, trust, or insured's spouse or estate is named beneficiary in a policy, the corporation either directly or indirectly is a beneficiary under the policy because the proceeds will be used to discharge its obligation to redeem the stock. Consequently, the corporation cannot deduct the premium payments (Q 247).[2]

Moreover, regardless of who is named beneficiary, premium payments are not taxable income to stockholders if a corporation owns the policy and the right of a beneficiary to receive proceeds is conditioned on the transfer of stock to the corporation (Q 251).

Death Proceeds

Death proceeds ordinarily are received tax-free.[3] Death proceeds may be subject to tax, however, under the corporate alternative minimum tax (Q 300).[4] In addition, death proceeds may be taxable if requirements for employer-owned life insurance are not met (Q 263).

Cost Basis

Because proceeds become part of a corporation's general assets, the value of stock owned by each surviving stockholder will be increased by a share, proportionate to his or her stock interest, of the difference between the death proceeds and the cash surrender value prior to death. The cost basis of a survivor's stock will not be increased. Consequently, the increase in value due to the insurance may result in some additional gain if a survivor sells the stock during the survivor's lifetime. If a survivor holds the stock until death, the stock will receive a new tax basis equal to its fair market value at the time of the survivor's death, thus eliminating this effect. Decedents who died in 2010, however, may not receive a full step up in basis.[5]

For the result under a stock purchase plan, see Q 284.

In the case of an S corporation, each shareholder's basis is increased by the shareholder's share of the tax-free death proceeds when they are received by the corporation.[6]

1. *Pulliam v. Comm.*, TC Memo 1984-470; Rev. Rul. 69-608, 1969-2 CB 42.
2. IRC Secs. 162(a), 264(a)(1); Rev. Rul. 70-117, 1970-1 CB 30.
3. IRC Sec. 101(a).
4. IRC Sec. 56.
5. IRC Sec.1022.
6. See IRC Sec. 1367.

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A corporation has no income tax basis problem; even if redeemed stock is carried as treasury stock and subsequently is resold, the corporation realizes no gain regardless of basis.[1]

Effect on Corporate Earnings and Profits

Revenue Ruling 54-230[2] states that earnings and profits will be increased by the excess of insurance proceeds over aggregate premiums paid, apparently on the assumption that no part of premiums have been deducted from earnings and profits.4 For taxable years beginning after July 18, 1984, if a corporation distributes amounts in a redemption under IRC Sections 302(a) or 303, the part of the distribution properly chargeable to earnings and profits is an amount not in excess of the ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, attributable to the stock redeemed.[3] The Conference Committee Reports from TRA 1984 indicate that priorities between different classes of stock may be taken into account in allocating earnings between classes and that redemption of preferred stock that is not convertible or participating to any significant extent in corporate growth should be charged to the capital account only.[4]

See also "Accumulated Earnings Tax," Q 293.

Accumulated Earnings tax

293. Will the accumulated earnings tax be imposed where corporate earnings are used to purchase business life insurance?

The accumulated earnings tax is imposed when a corporation, to prevent profits from being taxed to shareholders, retains earnings not needed in the business.[5] JGTRRA 2003 reduced the accumulated earnings tax rate to 15 percent (Q 665). For tax years beginning after 2012, the American Taxpayer Relief Act of 2012 increased the accumulated earnings tax rate to 20 percent.

In computing the amount of income subject to the tax, a credit is allowed for accumulations to meet reasonable current and anticipated business needs. Consequently, the tax should not be imposed on income retained for the purchase of life insurance if the insurance serves a valid business need and generally is related to that need.[6]

The purchase of life insurance to compensate a corporation for loss of a key person's service through early death is a reasonable business need and earnings used for that purpose therefore are not subject to the penalty tax.[7] *Emeloid Co.*, although not an accumulated earnings tax case, is excellent authority for the proposition that key person life insurance is a reasonable business need.

1. IRC Sec. 1032(a); Treas. Reg. §1.1032-1(a).
2. 1954-1 CB 114.
3. IRC Sec. 312(n)(7).
4. H.R. Conf. Rep. No. 98-861 (TRA '84) *reprinted in* 1984-3 CB (vol. 2) 94.
5. IRC Sec. 531, as amended by the American Taxpayer Relief Act of 2012, Pub. Law No. 112-240, Sec. 102(d)(1).
6. See *General Smelting Co. v. Comm.*, 4 TC 313 (1944).
7. *Harry A. Koch Co. v. Vinal*, 782 F. Supp. 762, 13 AFTR 2d 1241 (D. Neb. 1964), nonacq. 1965-1 CB 246; *Vuono-Lione, Inc. v. Comm.*, TC Memo 1965-96; see also *Emeloid Co. v. Comm.*, 189 F.2d 230 (3rd Cir. 1951).

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In *Novelart Mfg. Co. v. Comm.*,[1] premiums for key person life insurance were included in the taxable base on which the accumulated earnings tax is imposed. The taxpayer failed to argue that because key person life insurance is a reasonable business need, the premiums should be included in the calculation of the accumulated earnings credit. Instead, the taxpayer argued only that the amounts paid out for life insurance premiums no longer were available for distribution and should not be included in the measure of the tax because the tax is imposed on what is accumulated rather than on what is distributed. The argument was dismissed as inconsistent with the rules in the IRC for calculating the tax.

It also has been held that the cash surrender value of key person life insurance is not considered a liquid asset, along with cash and marketable securities, in determining whether further accumulations to finance plans for business expansion are necessary.[2]

An accumulation of earnings to meet a corporation's obligations incurred under a deferred compensation agreement should be considered a reasonable business need.[3]

Under certain circumstances, including to promote corporate harmony or management efficiency or to enable a corporation to continue its accustomed practices or policies, an accumulation of earnings to fund a stock redemption may constitute an accumulation for a reasonable need of the business.[4] Several cases do not deal with the accumulated earnings tax but contain persuasive statements concerning the business need for life insurance to fund close corporation stock redemptions.[5]

Several cases, not involving life insurance, have held that an accumulation of income for the purpose of affecting an IRC Section 303 redemption (Q 288) serves the purpose of an individual stockholder rather than a corporation. The effect of these cases is limited by IRC Section 537, which provides that the phrase "reasonable needs of the business" includes a business's IRC Section 303 redemption needs. The IRC language is not clear on the extent to which accumulations in years prior to a stockholder's death are to have protection from the tax. The IRC limits the amount of tax-sheltered accumulation in the year of a stockholder's death or in a subsequent year. Regulations provide that the reasonableness of accumulations in years prior to a year in which a shareholder dies is to be determined solely on the facts and circumstances existing at the times the accumulations occur.[6]

Planning Point: To avoid the accumulated earnings tax, a corporation should document the reason for retained earnings or the reason for the purchase of corporate owned life insurance. Contemporaneous documentation of the business need will go a long way toward avoiding this tax.

1. 52 TC 794 (1969), *aff'd*, 434 F2d 1011, 26 AFTR 2d 70-5837 (6th Cir. 1970).
2. *Motor Fuel Carriers, Inc. v. Comm.*, 77-2 USTC ¶9661 (5th Cir. 1977).
3. *John P. Scripps Newspapers v. Comm.*, 44 TC 453 (1965); *Okla. Press Pub. Co. v. U.S.*, 35 AFTR 2d 1383 (10th Cir. 1971), on remand, 28 AFTR 2d 5722 (E.D. Okla. 1971); see Treas. Reg. §1.537-2(b)(3).
4. *Mountain State Steel Foundries, Inc. v. Comm.*, 284 F2d 737,6 AFTR 2d 5910 (4th Cir. 1960); *Oman Construction Co. v. Comm.*, TC Memo 1965-325. But see also *John B. Lambert & Assoc. v. U.S.*, 76-2 USTC ¶9776 (Ct. Cl. 1976).
5. *Emeloid Co. v. Comm.*, supra; Sanders v. Fox, 253 F.2d 855 (10th Cir. 1958); *Prunier v. Comm.*, 248 F.2d 818 (1st Cir. 1957).
6. Treas. Reg. §1.537-1(e)(3).

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In the case of a professional corporation (Q 665), a stock redemption following a shareholder's death usually is not made under IRC Section 303 but is a complete redemption of all shareholder stock under IRC Section 302 (Q 285). The requirement of many state laws that a corporation must purchase stock of a deceased or disqualified professional would appear to establish a valid business purpose for accumulations to fund such redemptions. Consequently, an accumulation under these circumstances, particularly if funded by life insurance, should be immune from imposition of the accumulated earnings tax.

S Corporations

294. How is gain realized by an S corporation on sale, surrender, or redemption of a life insurance or endowment policy taxed?

Each stockholder's pro rata share of any gain received by an S corporation, such as gain on endowment maturity or from sale or surrender of a life insurance policy, will be included in a stockholder's gross income and will increase his or her basis in the stock.[1]

295. If an S corporation redeems a shareholder's stock, how are redemption payments taxed?

If an S corporation has no accumulated earnings and profits from when it was a C corporation or as a result of a corporate acquisition, then a redemption of stock will be treated as a capital transaction. That is, it will be tax-free to the extent of the shareholder's basis and any excess will be treated as capital gain.[2]

If an S corporation has accumulated earnings and profits, however, then part of the payment by the corporation could be treated as a dividend.[3] The exceptions to dividend treatment under IRC Sections 302(a) and 303(a) are available to S corporations (Q 285 to Q 288).

Sale or Liquidation of Partnership Interest

296. What are the income tax consequences when a deceased partner's interest is liquidated under a business purchase agreement?

The term "liquidation" refers to termination of a partner's entire interest by means of a distribution or series of distributions by a partnership. This is an entity redemption plan.[4] The term sale refers to purchase of a deceased's partnership interest by a surviving partner or partners individually; this is a cross-purchase plan.[5] Sale of a deceased partner's interest under a business purchase agreement is discussed in Q 297.

The portion of a partnership's payment that is allocable to a deceased partner's interest in partnership property is treated as a distribution, or payment for the purchase of a capital asset.[6]

1. IRC Secs. 1366(a)(1), 1367(a)(1)(A).
2. IRC Sec. 1368(b).
3. IRC Sec. 1368(c).
4. IRC Sec. 761(d).
5. IRC Sec. 741.
6. IRC Sec. 736(b).

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If capital is not a material income-producing factor for a partnership and a deceased partner was a general partner, then payments for an interest in partnership property will not include unrealized receivables or goodwill unless the partnership agreement provides for payments for goodwill.[1]

The estate or other successor in interest should realize no gain or loss if a partnership has elected to adjust the basis of partnership property to reflect the new basis of the deceased's partnership interest since that basis will be determined under stepped-up basis rules. Generally, the valuation placed by partners on a partner's interest in partnership property in an arm's length agreement will be regarded as correct.

The amount of any money or the fair market value of any property received by a partner in exchange for all or a part of the partner's interest in the partnership attributable to unrealized receivables of the partnership or inventory items of the partnership is considered an amount realized from a sale or exchange of property other than a capital asset. Amounts realized from a sale of property other than a capital asset generally are treated as ordinary income to the extent of gain.

The basis of these items also may be adjusted if a partnership elects. Payments for a deceased's interest in partnership property are not deductible by a partnership, but they increase, pro rata, the basis for each remaining partner's partnership interest.

Under a liquidation agreement, partners may elect to treat amounts paid for goodwill as either the purchase price for a capital asset or as ordinary income. For partners retiring or dying on or after January 5, 1993, or for payments made under a written contract that was binding as of January 4, 1993, an additional requirement applies to the election to treat goodwill as ordinary income. This treatment may be elected only if capital is not a material income-producing factor in a partnership and a retiring or deceased partner was a general partner.[2]

Where an agreement provides that part of the purchase price is for goodwill, the amount allocable to goodwill also will be treated as having been paid for a deceased's interest in partnership property. Regulations state that payment for goodwill, to be treated as a capital transaction, must be reasonable. However, the value placed on goodwill by partners in an arm's length agreement, whether specific in amount or determined by formula, generally will be regarded as the correct value.[3]

If the material income-producing factor/general partner requirements mentioned above are met and the agreement makes no provision for goodwill, or stipulates that payment for goodwill is to be treated as income, the amount paid for goodwill is taxable as ordinary income to the estate or other recipient. If treated as ordinary income, it is deductible by the partnership.[4]

1. IRC Sec. 736(b)(3).
2. IRC Sec. 736(b)(3).
3. Treas. Reg. §1.736-1(b)(3).
4. IRC Sec. 736(b)(2).

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Election to treat payment for goodwill as a capital investment or ordinary income may be made either in the original articles of partnership or in a subsequent business purchase agreement.[1] The IRS has ruled that determination as to whether a professional practice has saleable goodwill will be made on the basis of all the facts in a particular case and not on the basis of whether a business is dependent solely on the personal characteristics of the owner.[2]

The portion of a partnership payment that is allocable to a deceased's interest in unrealized receivables or inventory items of a partnership is ordinary income to the estate or other recipient.[3] Unrealized receivables include accounts receivable that were not previously includable in taxable income of partners and depreciation that is treated as ordinary income under IRC Sections 1245 and 1250 on the sale of depreciable property.[4] In determining the value of unrealized receivables, full account will be taken of the estimated cost of completing performance of the contract and of the time between the sale and time of payment.[5] Payments for unrealized receivables are deductible by a partnership.[6]

Any additional amounts paid by a partnership are treated as ordinary income (Q 298).

Ordinary income payments in a liquidation of a deceased partner's interest are income in respect of a decedent.[7] Consequently, a recipient of the income is entitled to an income tax deduction for any portion of the federal death taxes, including the generation-skipping transfer tax imposed on a taxable termination or a direct skip occurring as a result of a decedent's death, paid by the decedent's estate that is attributable to the value of that income.[8]

A partnership, even a two person partnership, will not be considered to have terminated so long as liquidation payments under IRC Section 736 are being made.[9]

297. What are the income tax consequences when a deceased partner's interest is sold under a business purchase agreement?

Where a deceased partner's interest is sold to a surviving partner or partners as individuals, the income tax results with respect to the purchase of the deceased's interest in partnership property essentially are the same as in a liquidation (see Q 296). This portion of a purchase is considered a capital transaction for purposes of determining gain or loss to a deceased's estate.

A survivor's interests in partnership property receives an increase in basis for this portion of the payment.[10] A slight difference in tax law exists, however, between a liquidation and a sale

1. *Jackson Investment Co. v. Comm.*, 346 F2d 187, 15 AFTR 2d 1125 (9th Cir. 1965).
2. Rev. Rul. 64-235, 1964-2 CB 18, as modified by Rev. Rul. 70-45, 1970-1 CB 17.
3. IRC Sec. 751(a).
4. See IRC Sec. 751.
5. Treas. Reg. §1.751-1(c)(3).
6. IRC Sec. 736(a); Treas. Reg. §1.736-1(a)(4).
7. IRC Sec. 753.
8. IRC Sec. 691(c).
9. Treas. Reg. §1.708-1(b)(1)(i); Treas. Reg. §1.736-1(a)(6).
10. IRC Sec. 742.

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with respect to payment for goodwill. In a sale, payments for goodwill must be treated as part of a capital transaction; partners do not have an option to treat these payments as ordinary income.[1]

Payments for unrealized receivables, as in a liquidation, are taxable as ordinary income to a deceased's estate or other recipient. Unrealized receivables generally are income in respect of a decedent and therefore do not receive a new basis because of the death of a partner even though an election to adjust basis is in effect.[2] Survivors cannot deduct their payments for unrealized receivables. They can elect, on behalf of the partnership, to adjust the basis of partnership assets. By such an election, the partnership's basis for its unrealized receivables, which usually is zero, is stepped-up for the benefit of each purchasing partner to reflect the amount he or she paid for his or her share of the receivables. Thus, when receivables are collected by a partnership, each partner's share will result in ordinary income only to the extent that it exceeds the price the partner paid for his or her interest in the receivables.[3]

298. What are the income tax results of a partnership income continuation plan?

A partnership can agree to make payments to a retiring partner or to the estate or beneficiary of a deceased partner, other than payments in liquidation of that partner's partnership interest. The payments either may be periodic guaranteed amounts or a share of future profits. In either case, the payments will be taxed as ordinary income to the payee.[4]

Payments of a guaranteed amount will be deductible by a partnership.[5]

Similarly, payments representing a share of profits will reduce the remaining or surviving partners' share of distributable taxable income.[6]

This tax treatment applies only to payments made by a partnership as an entity and not to payments made by individual remaining or surviving partners. A partnership, even a two person partnership, will not be considered as having terminated so long as these payments are being made because partners' interests have not been liquidated.[7]

299. What is the tax treatment of life insurance purchased to fund a partnership business purchase agreement?

Premiums are not deductible whether paid by individual partners or by a partnership (Q 257).[8] Assuming the requirements for employer-owned life insurance are met and there has not been a violation of the transfer for value rule, death proceeds are exempt from income tax whether received by partners or the partnership (Q 263).[9]

1. *Karan v. Comm.*, 319 F.2d 303 (7th Cir. 1963).
2. *Woodhall v. Comm.*,454 F2d 226, 29 AFTR 2d 72-394 (9th Cir. 1972).
3. IRC Secs. 754, 743.
4. Rev. Rul. 71-507, 1971-2 CB 331.
5. Treas. Reg. §1.736-1(a)(4).
6. IRC Sec. 736(a).
7. Treas. Reg. §1.736-1(a)(6).
8. IRC Sec. 264(a)(1).
9. IRC Sec. 101(a).

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The basis to partners of their partnership interests is increased by proceeds received by the partnership.[1]

Similarly, under a cross-purchase plan, each partner's basis for his or her partnership interest will be increased by the amount the partner pays for his or her share of a deceased partner's interest.[2]

If an insured is a partner in a partnership, policies can be freely sold or exchanged between partners, or between partners and the partnership. without fear of adverse tax consequences from the transfer for value rule (Q 274).

Even though proceeds are made payable directly to an insured's personal beneficiary, a survivor may be able to include the proceeds in his or her cost basis if there is a legally binding agreement between the partners to apply the proceeds to the purchase of the business interest.[3]

Alternative Minimum Tax

300. How is corporate-owned life insurance treated for purposes of the corporate alternative minimum tax?

Unless it qualifies for the small corporation exemption, a corporation may be subject to the corporate alternative minimum tax ("AMT"). Calculation of this fairly complicated tax is discussed generally in Q 665. One component of the corporate AMT, known as the adjusted current earnings ("ACE") adjustment, has a potential effect on corporate-owned life insurance policies.

A C corporation must adjust its reported income to reflect its adjusted current earnings ("ACE") or, before 1990, its book income. Inside buildup and payment of death proceeds of corporate-owned life insurance will affect an ACE adjustment. Death proceeds will not necessarily subject a corporation to the AMT because life insurance is only one of many factors considered when determining whether a corporation must pay the AMT.

A corporation's alternative minimum taxable income ("AMTI") generally is increased by 75 percent of any excess of the corporation's ACE divided by the corporation's AMTI. For negative adjustments, a corporation's AMTI is reduced by 75 percent of any excess of the corporation's AMTI divided by the corporation's ACE.[4]

Regulations offer the guidelines set forth below with respect to the effect of corporate-owned life insurance contracts on ACE.[5]

Inside Buildup

Income on a contract with respect to a tax year is included in ACE for the year except for a tax year in which an insured dies or a year in which the contract is completely surrendered

1. IRC Sec. 705(a)(1).
2. IRC Sec. 1012.
3. See *Mushro v. Comm.*, 50 TC 43 (1968), *nonacq.* 1970-2 CB xxii. But see *Legallet v. Comm.*, 41 BTA 294 (1940).
4. IRC Sec. 56(g).
5. Treas. Reg. §1.56(g)-1(c)(5).

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for its entire net surrender value. The income is calculated from the beginning of the tax year to the date of any distribution, from immediately after any distribution to the date of the next distribution, and from the last distribution in the tax year through the end of the tax year.

Solely for purposes of computing ACE, basis in a contract is increased for positive income on the contract included in ACE. The income on a contract for ACE is (1) the contract's net surrender value at the end of the period plus any distributions during the period that are not taxed because they represent return of basis in the contract for purposes of ACE, minus (2) the net surrender value at the end of the preceding period plus any premiums paid during the period.

Distributions

A distribution, whether a partial withdrawal or an amount received on complete surrender, is included in ACE under IRC Section 72(e) (Q 10), taking into account a taxpayer's basis for purposes of computing ACE. The basis is the same as the basis for ACE at the end of the immediately preceding period plus premiums paid before a distribution.

The basis in a contract for purposes of ACE is reduced by the amount not included in ACE because it represents recovery of ACE basis. If ACE basis in a contract exceeds death benefits received, the resulting loss may be deducted from ACE.

Death Benefits

Death benefits generally are excluded from gross income under IRC Section 101. Major exceptions include if COLI Best Practices Act provisions are not met or if the transfer for value rule is violated.

The excess of contractual death benefits over a taxpayer's basis for purposes of ACE at the time of death is included in ACE.

Any outstanding policy loan treated as discharged or forgiven on the death of an insured is included in the amount of the death benefit.

Term Life Insurance without Net Surrender Value

ACE is reduced by premiums paid to the extent allocable to coverage provided during the year; premiums not so allocable must be included in basis. A death benefit is included in ACE as explained above.

Policies Involving Divided Ownership

The above requirements apply to separate ownership interests as though each interest were a separate contract.

Example. Brown Corporation has a policy with a net surrender value of $14,774 as of the end of 2013. The policy had a surrender value of $11,231 at the end of 2012 and a basis of $9,821 as a result of $8,800 in aggregate premiums paid plus $1,021 included in ACE as inside buildup in 2012. Brown Corporation paid a premium of $2,200 in 2013. The corporation must include in ACE for 2013 $1,343 ($14,774 - [$11,231 + $2,200]).

The basis in the contract for purposes of ACE is increased by $1,343 of income on the contract included in ACE for 2013 and the $2,200 premium paid in 2013 for a total of $13,364.

Assume instead that, in 2013, Mrs. Brown, the insured, dies after the $2,200 premium was paid and Brown Corporation received the $100,000 death benefit. No amount of inside buildup is included in income; instead, the corporation must include in ACE the excess of the death benefit over the basis for ACE, $87,979 ($100,000-[$9,821 + $2,200]).

Now, assume that Mrs. Brown did not die in 2013. Brown Corporation paid a premium of $2,200 in 2014 and received a distribution of $16,200 on February 1, 2014, leaving a net surrender value of $915. On March 1, 2014, Brown Corporation pays an additional premium of $5,000. The net surrender value of the contract at the end of 2014 is $6,417. Brown Corporation must include $636 of the distribution in income: $16,200 (distribution) - $15,564 (basis for ACE as of the time of the distribution).

The income on the contract includable in ACE for 2014 is determined separately for the period before the distribution and the period after it. There is no income on the contract for the period beginning January 1, 2014 and ending at the time of the distribution on February 1, 2014: [$915 (net surrender value at the end of the period) + $15,564 (distribution of basis)] - [$14,774 (net surrender value at the end of 2013) + $2,200 (premiums paid during the period)] = ($495). Because the net result is negative, no income is included for this period.

Income on the contract for the period beginning immediately after the distribution through the end of the taxable year is $502: $6,417 (net surrender value at the end of 2014) - [$915 (net surrender value at the end of the preceding period) + $5,000 (premiums paid during the period)].

At the end of 2014, Brown Corporation's basis in the contract for ACE is $5,502: $502 (income on the contract) + $5,000 (premium) + $0 (the basis at the end of the previous period). Brown Corporation includes in ACE in 2014 a total of $1,138 ($502 income on the contract) + $636 (income from distribution).[1]

Estate Tax Issues

Insurance on Key Persons, Partners, Stockholders

301. If a partnership purchases and owns life insurance on the life of a partner, are policy proceeds includable in the insured partner's estate?

If a partnership is both policy owner and beneficiary, insurance proceeds are not includable in an insured's gross estate under the incidents of ownership test (Q 80).[2]

Proceeds received by a partnership will be included with other partnership assets in determining the value of a decedent's partnership interest for estate tax purposes; consequently, his or her gross estate will reflect a share of the proceeds proportionate to his or her partnership interest.[3]

If an insured has personal incidents of ownership in a policy, including the right to change a beneficiary, the entire value of the proceeds will be includable in his or her gross estate.[4]

1. See Treas. Reg. §1.56(g)-1(c)(5)(vii).
2. *Est. of Knipp v. Comm.*, 25 TC 153 (1955), acq. in result, 1959-1 CB 4; *Est. of Atkins v. Comm.*, 2 TC 332 (1943); Rev. Rul. 83-147, 1983-2 CB 158.
3. See IRC Sec. 2033.
4. See IRC Sec. 2042(2); Hall v. Wheeler, 174 F. Supp. 418 (D. Me. 1959); *Est. of Piggott v. Comm.*, TC Memo 1963-61, aff'd, 340 F.2d 829 (6th Cir. 1965).

Where death proceeds are payable to a partner's personal beneficiary, the insured is deemed to own an incident of ownership in the insurance in his or her capacity as a partner for purposes of IRC Section 2042(2) regardless of the percentage of the partnership interest; consequently, if a partnership owns insurance at the time of an insured partner's death, the entire proceeds will be includable in the partner's estate.[1]

For estate tax treatment of group term life insurance covering the life of a partner, see Q 170.

302. If a corporation purchases life insurance on the life of a key person to indemnify it against loss on account of the key person's death, are proceeds includable in the insured's estate?

If, at an insured's death, a policy was owned by and payable to a corporation and the insured possessed no incidents of ownership in the policy (Q 80, Q 81), proceeds are not includable in the insured's gross estate. If the insured possessed at his or her death any incidents of ownership in the policy, the proceeds are includable in his or her gross estate even though the corporation has been named owner and beneficiary.[2]

Death proceeds of life insurance owned by and payable to a corporation are considered, along with the other non-operating assets, as a relevant factor in valuing a corporation's stock for estate tax purposes (but see Q 304).[3] Consequently, where an insured is a stockholder, the value of proceeds will be reflected in valuing stock includable in the insured's gross estate.[4] It is not correct to value the stock first, without considering the insurance proceeds, and then simply add the amount of proceeds to that value.[5] Factoring life insurance proceeds into the valuation of stock may or may not result in an increase in value equal to the full value of the insurance proceeds, depending on the valuation method.[6] An offset may be available where there is an obligation to pay insurance proceeds to another party under a buy-sell agreement.[7]

It may be possible to obtain some reduction in the value of stock to reflect loss to the business of the key person's services.[8] The executor must offer proof to establish that the insured's death actually did cause a loss. A loss does not result per se from the death of the owner and manager of a corporation.[9]

It has been held that no decrease in value for loss of an insured's services will be allowed if the stock is a personal holding company's stock whose assets consist almost entirely of stocks

1. Rev. Rul. 83-147, 1983-2 CB 158; GCM 39034 (9-21-83).
2. IRC Sec. 2042(2); *Est. of Piggott v. Comm.*, 340 F.2d 829 (6th Cir. 1965), *aff'g* TC Memo 1963-61; *Hall v. Wheeler*, 174 F. Supp. 418 (D. Me. 1959); *Kearns v. U.S.*, 399 F.2d 226 (Ct. Cl. 1968); *Est. of Cockrill v. O'Hara*, 302 F. Supp. 1365 (M.D. Tenn. 1969).
3. Treas. Reg. §20.2031-2(f).
4. *Est. of Blair v. Comm.*, 4 BTA 959 (1926), nonacq. 1927-1 CB 7; *Est. of Doerken v. Comm.*, 46 BTA 809 (1926); *In re Patton's Will*, 278 N.W. 866 (Wisc. 1938); *In re Reed's Est.*, 153 N.E. 47 (N.Y. 1926); *Kennedy v. Comm.*, 4 BTA 330 (1926); *Est. of Carew v. Comm.*, 311 A2d 185 (N.J. 1973).
5. *Est. of Huntsman v. Comm.*, 66 TC 861 (1976), *acq.* 1977-1 CB 1.
6. *Est. of Blount v. Comm.*, TC Memo 2004-116.
7. *Est. of Blount v. Comm.*, 428 F.3d 1338 (11th Cir. 2005).
8. Rev. Rul. 59-60, 1959-1 CB 237; *Newell v. Comm.*, 66 F.2d 102 (7th Cir. 1933); *Est. of Huntsman*, supra.
9. *Est. of Scherer v. Comm.*, 1940 P-H BTA Memorandum Decisions ¶40,530.

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and bonds; a corporation must be an operating business requiring management, with going value and good will.[1]

If an insured is a controlling stockholder, that is, one who owns stock amounting to more than 50 percent of the total combined voting power of the corporation, then to the extent proceeds are payable other than to or for the benefit of the corporation, any incidents of ownership in the insurance held by the corporation as to the proceeds will be attributed to the insured and thereby will cause the proceeds to be includable in the insured's gross estate.[2]

In Rev. Rul. 82-141,[3] X corporation owned insurance on the life of its controlling stockholder, D. The corporation assigned all of its incidents of ownership in the policy to A. D died in 1981, within three years of the assignment, and proceeds of the policy were paid to A. The IRS held that the proceeds were includable in D's estate under IRC Section 2035 (Q 91) by reason of attribution to D of the incidents of ownership held by the corporation. The ruling failed to identify the policy's beneficiary before the assignment.

The IRS also held that proceeds were includable in an insured's estate under IRC Section 2035 where a corporation transferred a policy insuring the controlling shareholder to a third person within three years of the insured's death even though the insured disposed of the insured's stock after the transfer of the policy and prior to the insured's death.[4]

Proceeds also were includable in an insured's estate where a corporation retained ownership of a policy and an insured transferred enough stock so as to cease being a controlling shareholder within three years of death (Q 308).[5]

303. If partners or stockholders enter into a buy-sell agreement and each purchases life insurance on each other's lives to fund the agreement, are proceeds includable in an insured's gross estate?

If, under a cross-purchase arrangement, proceeds are not payable to an insured's estate, and an insured has no incidents of ownership in the policies on his or her life, proceeds are not includable in his or her gross estate.[6]

The Tax Court has held that a provision in an agreement prohibiting a policy owner from surrendering the policy, borrowing against the policy, or changing the beneficiary of the policy without the insured's consent did not give the insured incidents of ownership in the policy (but see Q 81).[7] The value of an insured's partnership interest or corporate stock is includable.[8] The value of any unmatured policies an insured owns on the life of his or her associates also will be includable.

1. *In re Patton's Will*, supra.
2. Treas. Reg. §20.2042-1(c)(6).
3. 1982-2 CB 209.
4. Rev. Rul. 90-21, 1990-1 CB 172, Situation 1.
5. Rev. Rul. 90-21, 1990-1 CB 172, Situation 2.
6. IRC Sec. 2042; Rev. Rul. 56-397, 1956-2 CB 599.
7. *Est. of Infante v. Comm.*, TC Memo 1970-206 (appeal dismissed).
8. *Est. of Riecker v. Comm.*, 3 TCM 1293 (1944).

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Where proceeds are includable in the gross estate but the estate is obligated to apply them to the purchase price of the insured's business interest, the value of the business interest will be includable in the gross estate only to the extent that it exceeds the value of the proceeds. In other words, there will be no double taxation.[1]

There is some legal authority to the effect that terms of a policy can be modified by terms of a business agreement. Thus, where an agreement gives all beneficial ownership in proceeds to an insured's co-partners and obligates the parties to apply them to the purchase of the insured's business interest, proceeds are not included in the insured's gross estate despite a policy provision giving the insured the right to change the beneficiary.[2]

304. If life insurance is owned by and payable to a partnership or corporation to fund purchase of an owner's business interest, are proceeds includable in the insured owner's estate?

No.

Because proceeds are not payable to an insured's estate and the insured has no incidents of ownership in the policy, at least in the insured's capacity as an individual, the proceeds are not includable in the insured's gross estate.[3] The same result should occur where a business owns the insurance but proceeds are payable to a trustee who must use them to purchase an insured's business interest for the partnership or corporation.

The value of a business interest is, of course, includable in an insured's gross estate.[4]

In valuing an insured's business interest, the part of the proceeds that is proportionate to the insured's interest in the business will be included unless the proceeds are excluded from the purchase price under the terms of an agreement and the agreement is effective in fixing the value of the business interest for estate tax purposes (Q 305).[5]

Where an insured is a controlling stockholder, incidents of ownership in insurance owned by the corporation are not attributable to the insured so as to cause death proceeds to be includable in the decedent's gross estate under IRC Section 2042 (Q 302).[6]

305. How is a closely held business interest valued for federal estate tax purposes where there is a purchase agreement?

For purchase agreements entered into after October 8, 1990, or substantially modified after that date, the value of a closely held business interest is to be determined without regard to any

1. *Est. of Mitchell v. Comm.*, 37 BTA 1 (1938), *acq.*; *Est. of Tompkins v. Comm.*, 13 TC 1054 (1949), *acq.*; *Est. of Ealy v. Comm.*,10 TCM 431; *Dobrzensky v. Comm.*, 34 BTA 305 (1936), nonacq. 1936-2 CB 39; *Boston Safe Deposit & Trust Co. v. Comm.*, 30 BTA 679 (1934), nonacq. 1934-2 CB 34.
2. *Est. of Fuchs v. Comm.*, 47 TC 199 (1966), *acq.* 1967-2 CB 2; *First Nat'l Bank of Birmingham v. U.S.*, 358 F.2d 625 (5th Cir. 1966).
3. IRC Sec. 2042; *Est. of Knipp v. Comm.*, 25 TC 153 (1955), *acq. in result*, 1959-1 CB 4; Rev. Rul. 83-147, 1983-2 CB 158.
4. *Wilson v. Crooks*, 52 F.2d 692 (W.D. Mo. 1931); *Est. of Ealy v. Comm.*, 10 TCM 431 (1951); *Est. of Riecker v. Comm.*, 3 TCM 1293 (1944); *Est. of Atkins v. Comm.*, 2 TC 332 (1943); *Est. of Knipp*, supra.
5. *Newell v. Comm.*, 66 F.2d 102 (7th Cir. 1933); *Kennedy v. Comm.*, 4 BTA 330 (1926); see also *Est. of Salt v. Comm.*, 17 TC 92 (1952); *Est. of Littick v. Comm.*, 31 TC 181 (1958), *acq. in result* 1984-2 CB 1; *Rubel v. Rubel*, 75 So. 2d 59 (Miss. 1954).
6. Treas. Reg. §20.2042-1(c)(6); Rev. Rul. 82-85, 1982-1 CB 137. See also *Est. of Huntsman v. Comm.*, 66 TC 861 (1976), acq. 1977-1 CB 1.

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purchase agreement exercisable at less than fair market value, determined without regard to the purchase agreement, unless the purchase agreement:

(1) is a bona fide business arrangement;

(2) is not a device to transfer property to members of the decedent's family for less than full or adequate consideration in money or money's worth; and

(3) has terms comparable to those entered into by persons in an arm's length transaction.[1]

Whether or not an agreement is subject to IRC Section 2703, case law has established the additional following rules:

(1) an estate must be obligated to sell at death under either a mandatory purchase agreement or an option held by the business or survivors;

(2) the price must be fixed by the terms of the agreement or the agreement must contain a formula or method for determining the price;

(3) the agreement must prohibit an owner from disposing of his or her interest during life without first offering it to the other party or parties at no more than the contract price;

(4) the price must be fair and adequate when the agreement is made.[2]

If a business purchase agreement calls for shares to be purchased from an estate with installment purchase notes bearing a rate of interest lower than the market rate at the date of death, an executor may be allowed to discount the value of the shares by the difference between the interest rate called for in the buy-sell agreement and the prevailing rate at the date of death.[3]

A first-offer agreement, under which survivors have no enforceable right to purchase the business interest and can purchase the interest only if the executor wishes to sell, does not fix the value of the interest for estate tax purposes.[4]

If an agreement is between closely related persons and is merely a scheme for avoiding estate taxes, the price set in the agreement will not control.[5]

1. See IRC Sec. 2703.
2. *May v. McGowan*, 194 F.2d 396 (2nd Cir. 1952); *Comm. v. Child's Est.*, 147 F.2d 368 (3rd Cir. 1945); *Comm. v. Bensel*, 100 F.2d 639 (3rd Cir. 1938); *Lomb v. Sugden*, 82 F.2d 166 (2nd Cir. 1936); *Wilson v. Bowers*, 57 F.2d 682 (2nd Cir. 1932); *Est. of Littick v. Comm.*, 31 TC 181 (1958), acq. in result 1984-2 CB 1; *Est. of Salt v. Comm.*, 17 TC 92 (1951), acq.; *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955); *Fiorito v. Comm.*, 33 TC 440 (1959), acq.; *Est. of Weil v. Comm.*, 22 TC 1267 (1954), acq.; *Est. of Bischoff v. Comm.*, 69 TC 32 (1977); see also Treas. Reg. §20.2031-2(h); Treas. Reg. §20.2031-3.
3. Let. Rul. 8245007.
4. *Worcester County Trust Co. v. Comm.*, 134 F.2d 578 (1st Cir. 1943); *City Bank Farmers Trust Co. v. Comm.*, 23 BTA 663 (1931), acq. 1932-1 CB 2; *Michigan Trust Co. v. Comm.*, 27 BTA 556 (1933).
5. *Slocum v. U.S.*, 256 F. Supp. 753 (S.D.N.Y. 1966).

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A buy-sell agreement is not binding unless it represents a bona fide business agreement and is not testamentary in nature.[1] An agreement may be found to be a scheme for avoiding estate taxes even where it serves a bona-fide business purpose.[2]

No effect will be given to an option or contract under which a decedent is free to dispose of the interest or shares at any price he or she chooses during life.[3]

On the other hand, an agreement that restricts sale during life, but not at death, will also fail to fix the estate tax value.[4]

306. How is a closely held business interest valued for federal estate tax purposes where there is no purchase agreement?

Valuation of closely held corporate stock requires a determination of fair market value. Estate tax regulations define this as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of the relevant facts."[5]

Factors that should be considered when determining fair market value include the company's net worth, prospective earnings and dividend paying capacity, goodwill, the economic outlook in the particular industry and its management, the degree of control of the business represented by the block of stock to be valued, and the value of securities of corporations engaged in the same or similar lines of business that are listed on a stock exchange.[6]

If a block of stock represents a controlling interest in a corporation, a control premium generally adds to the value of the stock. If, however, shares constitute a minority ownership interest, a minority discount often is used. A premium also may attach for swing vote attributes where one block of stock may exercise control by joining with another block of stock.[7] One memorandum valued stock included in a gross estate at a premium as a controlling interest, while applying a minority discount to a marital deduction portion that passed to a surviving spouse.[8]

Just because an interest being valued is a minority interest does not mean that a minority discount is available.[9] One case, however, valued stock with voting rights at no more than stock without voting rights.[10]

1. *Est. of True v. Comm.*, 390 F3d 1210 (10th Cir. 2004).
2. St. Louis County Bank v. U.S., 674 F2d 1207, 49 AFTR 2d 82-1509 (8th Cir. 1982).
3. *Est. of Caplan v. Comm.*, TC Memo 1974-39; *Est. of Gannon v. Comm.*, 21 TC 1073 (1954); *Est. of Trammell v. Comm.*, 18 TC 662 (1952), acq. 1953-1 CB 6; *Est. of Mathews v. Comm.*, 3 TC 525 (1944); *Hoffman v. Comm.*, 2 TC 1160 (1943); *Est. of Tompkins v. Comm.*, 13 TC 1054 (1949); Rev. Rul. 59-60, 1959-1 CB 237.
4. *Land v. U.S.*, 303 F.2d 170 (5th Cir. 1962).
5. Treas. Reg. §20.2031-1(b).
6. Treas. Reg. §20.2031-2. See also Rev. Rul. 59-60, 1959-1 CB 237.
7. TAM 9436005.
8. TAM 9403005.
9. *Godley v. Comm.*, 286 F.3d 210, 2002-1 USTC ¶60,436 (4th Cir. 2002) (partnerships held housing projects subject to long term government contracts).
10. *Est. of Simplot v. Comm.*, 249 F.3d 1191 (9th Cir. 2001).

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The Tax Court has held that if real estate is specially valued for estate tax purposes under IRC Section 2032A, an estate may not take a minority discount with respect to stock in a corporation that held the real estate.[1]

In a split decision, however, the Tenth Circuit Court of Appeals has ruled that minority discounts and special use valuation under IRC Section 2032A are not mutually exclusive; it would apply the minority discount to the fair market value of the real estate as owned through a partnership and then apply the $750,000 cap on special use valuation to the difference between fair market value as discounted and special use value of the real estate.[2]

The Fifth Circuit Court of Appeals has ruled that shares of stock in a decedent's estate were to be valued as a minority interest when the decedent owned less than 50 percent, despite the fact that control of the corporation was within the decedent's family. This was true even when, immediately before death, the decedent and the decedent's spouse owned more than 50 percent of the stock as community property. The court also ruled that family attribution (Q 285) would not apply to lump a decedent's stock with that of related parties for estate tax valuation purposes both because of prior case law and because applying attribution would be inconsistent with the willing buyer-willing seller rule.[3]

A minority discount will not be disallowed solely because a transferred interest would be part of a controlling interest if the interest were aggregated with interests held by family members.[4]

A minority discount was allowed even when the person to whom the interest was transferred already was a controlling shareholder.[5]

A couple of deathbed transactions, however, were aggregated into a single integrated transfer to which a control premium attached rather than minority discounts where a parent, a 60 percent shareholder, sold a 30 percent interest in a corporation to a child, a 20 percent shareholder and the parent had the corporation redeem the remaining 30 percent interest in the corporation held by the parent.[6]

The Tax Court has determined that an estate would not be allowed a minority discount where a decedent transferred a small amount of stock immediately prior to death for the sole purpose of reducing her interest from a controlling interest to a minority interest for valuation purposes.[7]

Similarly, the IRS has disallowed minority discounts while disregarding partnerships or limited liability companies created on a decedent's deathbed presumably to obtain minority discounts.[8]

1. *Est. of Maddox v. Comm.*, 93 TC 228 (1989).
2. *Est. of Hoover v. Comm.*, 69 F.3d 1044 (10th Cir. 1995) (*acq*. 1998-2 CB xix), *rev'g* 102 TC 777 (1994).
3. *Est. of Bright v. Comm.*, 658 F.2d 999 (5th Cir. 1981).
4. Rev. Rul. 93-12, 1993-1 CB 202.
5. TAM 9432001.
6. TAM 9504004.
7. *Est. of Murphy v. Comm.*, TC Memo 1990-472.
8. TAMs 9719006, 9723009, 9725002, 9730004, 9735003, 9736004, 9842003.

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A couple of courts have rejected the idea that a partnership can be ignored for purposes of IRC Section 2703.

A partnership or LLC entity may be included in a gross estate under IRC Section 2036 without the benefit of discounts under a number of circumstances. For example, if a decedent puts everything he or she owns into the entity, retains complete control over the income of the entity, uses the entity as a personal pocket book, or fails to follow entity formalities, the entity may be included in his or her gross estate.[1]

One case has held that IRC Section 2036 did not apply because the court concluded that the transfer to a partnership was a bona fide sale for adequate consideration.[2]

Partnership Income Continuation

307. Will the value of payments to a deceased partner's spouse, under a partnership income continuation agreement, be includable in the partner's estate?

Yes.

This is the result whether payments are of a guaranteed amount or a share of partnership profits for a certain number of years.[3] The value of guaranteed payments is their present value at date of death. The value of a share in future partnership profits is based on past profits referred to as the valuation date.[4] The payments are income in respect of a decedent.[5] Consequently, a beneficiary will be entitled to an income tax deduction for any estate tax attributable to including the value of payments in a decedent's gross estate.

Split Dollar Insurance Plan

308. Are proceeds of life insurance under a split dollar plan or under a reverse split dollar plan includable in an insured's gross estate?

A close reading of IRC Section 2042(2) (Q 76) leads to the conclusion that if an insured in a split dollar plan (Q 3898), including a reverse split dollar plan (Q 3905), has any incident of ownership in the policy at death, including the right to name a beneficiary of proceeds in excess of cash value or a right to name a beneficiary of the cash value in the case of a reverse split dollar plan, the entire proceeds would be includable in the insured's gross estate. IRC Section 2042(2) says, in pertinent part, that the value of a gross estate includes the value of all property to the extent "of the amount receivable by all other beneficiaries as insurance under policies on the

1. *Est. of Strangi v. Comm.*, 417 F. 3d 468, 2005-2 USTC ¶60,506 (5th Cir. 2005), *aff'g* TC Memo 2003-145; *Est. of Bongard v. Comm.*, 124 TC 95 (2005); *Est. of Bigelow v. Comm.*, 503 F. 3d 955, 2007-2 USTC ¶60,548 (9th Cir. 2007), *aff'g* TC Memo 2005-65; *Kimbell v. U.S.*, 244 F. Supp. 2d 700, 2003-1 USTC ¶60,455 (N.D. Tex. 2003), *rev'd 371 F. 3d 257*, 2004-1 USTC ¶60,486 (5th Cir. 2004); *Est. of Abraham v. Comm.*, TC Memo 2004-39; *Est. of Hilgren v. Comm.*, TC Memo 2004-46 (discount for business loan agreement was allowed); *Turnerv. Comm.*, 382 F. 3d 367, 2004-2 USTC ¶60,489 (3rd Cir. 2004), *aff'g* TC Memo 2002-246.
2. *Kimbell v. U.S.*, 371 F. 3d 257, 2004-1 USTC ¶60,486 (5th Cir. 2004), *rev'g 244 F. Supp. 200* 2003-1 USTC ¶60,455 (N.D. Tex. 2003).
3. Rev. Rul. 66-20, 1966-1 CB 214; Rev. Rul. 71-507, 1971-2 CB 331; *Est. of Riegelman v. Comm.*, 253 F.2d 315 (2nd Cir. 1958); *McClennen v. Comm.*, 131 F.2d 165 (1st Cir. 1942); *Est. of Beal v. Comm.*, 47 TC 269 (1966); *Winkle v. U.S.*, 160 F. Supp. 348 (W.D. Pa. 1958).
4. *Est. of Hull v. Comm.*, 38 TC 512 (1962).
5. IRC Secs. 753, 736(a).

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life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person." Notice in particular the phrases "all" other beneficiaries, that is, beneficiaries other than the insured's estate, and "any" of the incidents of ownership. The language certainly seems inclusive enough to call for the conclusion suggested. (See Rev. Ruls. 79-129, and 82-145, discussed in Q 309 and Q 311). Moreover, this seems to be the position of the Tax Court on the proper application of IRC Section 2042(2) to split dollar life insurance. (See the discussion of *Est. of Levy*, Q 311).

Estate tax results depend on the substance of the arrangement, meaning that it is important to examine who actually holds which incidents of ownership, rather than placing importance on whether an endorsement form or collateral assignment form is used (Q 3905). Estate tax results also are not altered depending on the source or purpose of premium payments.[1]

Does A Plan Create True Indebtedness?

In a usual split dollar plan, the portion of premiums paid by an employer or one who occupies this position in the arrangement is not a true loan. Although the employer or its successor expects ultimately to recover the amount from death proceeds, the usual agreement does not obligate the insured to repay the funds from any source other than the policy or otherwise to treat that amount as a debt.

For estate tax purposes, it may make a real difference whether or not a split dollar plan creates a true indebtedness. If there is an indebtedness, and if the entire proceeds are brought into an insured's gross estate under the incidents of ownership rule, the estate will be allowed a deduction under IRC Section 2053 for the amount of debt repaid from insurance proceeds. In this case, the net result will be the same as if only the portion of proceeds payable to the insured's beneficiary were included in the insured's gross estate in the first place. If there is no true indebtedness and if the entire proceeds are brought into an insured's gross estate under the incidents of ownership rule, the portion of the proceeds going to the employer or to whoever occupies its place in the arrangement cannot be taken as an IRC Section 2053 deduction by the estate.

For estate taxation on the death of a third party owner of a policy on the split dollar plan, see Q 195.

309. Are proceeds of life insurance under a split dollar plan or under a reverse split dollar plan includable in an insured's gross estate in the context of a non-employer-employee relationship?

In Revenue Ruling 79-129,[2] involving a split dollar arrangement not in the employer-employee context, the trustee of a funded irrevocable insurance trust created by the insured, D, for the benefit of D's spouse and children, was designated policy owner and beneficiary of proceeds of an ordinary life policy in excess of the cash surrender value at death. The trust provided that D would pay the portion of the annual premium equal to the annual increase in cash value. The

1. Rev. Rul. 76-274, 1976-2 CB 278.
2. 1979-1 CB 306.

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policy gave the insured the right to borrow against the cash surrender value up to the total of premiums paid by the insured, where the trustee owned all other policy rights, and designated D's estate as beneficiary of the portion of proceeds equal to the cash value at death less outstanding indebtedness. The IRS ruled that the entire proceeds, both the portion payable to D's estate and the portion payable to the trustee, were includable in D's estate under IRC Section 2042. (Q 178 discusses estate taxation of funds remaining from a premium payment fund on the death of a grantor-insured of an irrevocable funded life insurance trust).

Proceeds would not be includable in an insured's estate under IRC Section 2042(2) where the insured's spouse and an irrevocable trust created by the insured, but over which the insured retained no powers, entered into a split dollar arrangement and the insured held no incidents of ownership in the policy.[1]

A husband and wife would not be treated as holding incidents of ownership under IRC Section 2042(2) where the husband and wife transferred cash to an irrevocable trust, the trust purchased a second to die policy on the life of the husband and wife, and the husband and wife entered into a collateral assignment split dollar arrangement with the trust whereby the trust would pay a portion of the premium equal to term rates, the husband and wife would pay the balance of the premium, and the only right held by the husband and wife was to be reimbursed for their premium payments through receipt of cash surrender values in excess of cash surrender values at the end of the initial policy year.[2]

310. Are proceeds of life insurance under a split dollar plan or under a reverse split dollar plan includable in an insured's gross estate in the context of an employer-employee relationship?

In *Schwager v. Comm.*,[3] a sole proprietor applied for and owned a policy on a split dollar or endorsement plan on the life of an employee. The beneficiary of proceeds equal to the cash value at death was designated in the policy as the part A beneficiary and in this case was the employer. The beneficiary of proceeds in excess of the cash value, the part B beneficiary, was the employee's wife. By policy amendment, the part B beneficiary could not be changed without the insured's consent. The Tax Court decided that the insured's right to consent to a change of beneficiary was an incident of ownership and held that the portion of proceeds paid to his widow was includable in his estate. The opinion does not make it clear that only the portion of proceeds payable to the insured's widow was includable in the estate, but counsel for the taxpayer has confirmed that for us. Apparently, the IRS did not try for the includability of more.

In *Est. of Tomerlin v. Comm.*,[4] a corporation owned insurance on the life of a decedent, a 50 percent shareholder of the corporation. The policy provided that the corporation was the sole owner of the policy and that the death proceeds were to be divided between the corporation and the decedent's children. The corporation was to receive the proceeds equal to the premiums it

1. Let. Rul. 9636033.
2. Let. Rul. 9745019.
3. 64 TC 781 (1975).
4. TC Memo 1986-147.

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had paid and the decedent's children were to receive the balance. The decedent had been given incidents of ownership in the policy by agreement with the corporation, including the right to designate beneficiaries of the policy. The IRS sought includability in the decedent's estate under IRC Section 2042(2) of the portion of the proceeds payable to the decedent's children, and the court found for the IRS.

Letter Ruling 9026041 held that the full value of proceeds of a life insurance policy were subject to an endorsement reverse split dollar agreement and included in the estate of the insured key person. The insured key person would hold incidents of ownership in the policy. The estate would be allowed to deduct the portion of the proceeds that would be payable to the corporate participant in the reverse split dollar arrangement.

311. Are proceeds of life insurance under a split dollar plan or under a reverse split dollar plan includable in an insured's gross estate when a corporation owns split dollar insurance on the life of a controlling stockholder?

In the case of split dollar insurance owned by a corporation on the life of a controlling stockholder, special rules apply. Estate tax regulations provide the following:

> [I]f any part of the proceeds of the policy are not payable to or for the benefit of the corporation … any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through his stock ownership when the decedent is the sole or controlling stockholder. Thus, for example, if the decedent is the controlling stockholder in a corporation, and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership and the proceeds will be included in his gross estate under section 2042. If in this example the policy proceeds had been payable 40 percent to the decedent's spouse and 60 percent to the corporation, only 40 percent of the proceeds would be included in decedent's gross estate under section 2042.[1]

The above-quoted regulation attributes to a stockholder incidents of ownership held by a corporation "as to that part of the proceeds" not payable to or for the corporation. Apparently, the quoted phrase originally led the IRS to take a position as to which it later reversed itself. In Revenue Ruling 76-274 (Situation 3),[2] the IRS held that if, under a split dollar agreement, the corporation's incidents of ownership were limited to those appropriate to protecting its position as a lender of premium dollars (an incident such as the right to borrow against the policy but only to the extent of the portion of premiums it has advanced) so that the corporation's exercise of those rights could not impair the interests of the insured or the insured's personal beneficiary, the corporation's incidents of ownership would not be attributed to the insured.

1. Treas. Reg. §20.2042-1(c)(6), as amended April 29, 1974.
2. 1976-2 CB 278.

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In Revenue Ruling 82-145,[1] the IRS ruled that its conclusion in Situation 3 of Rev. Rul. 76-274 was incorrect and indeed was inconsistent with Rev. Rul. 79-129, discussed in Q 309. The IRS concluded that the incident of ownership described in Situation 3 of the 1976 ruling was attributable to the insured and that this attribution warrants inclusion of the entire amount of policy proceeds under IRC Section 2042(2). The IRS added, however, that "pursuant to the rule in section 20.2042-1(c)(6) adopted to prevent double taxation, to the extent that the proceeds are payable to the corporation, they are considered in valuing the decedent's stock under section 2031, rather than included under section 2042(2)." A grandfathering provision in the ruling reads as follows: "the conclusion in this revenue ruling reversing the holding in *Situation 3* of Rev. Rul. 76-274 will not be applied with respect to insurance policies obtained before [August 4, 1982], except to the extent, if any, that there has been an increase, after [August 4, 1982], in the amount of the insurance proceeds payable other than to or for the benefit of the corporation." (See Q 302).

Est. of Thompson v. Comm.,[2] a 1981 Tax Court case that supports the IRS's position in Rev. Rul. 82-145, concerned an employer-pay-all split dollar whole life policy owned by a corporation on the life of its president and sole owner, the decedent. Under the plan, death proceeds were divided between the corporation (the cash value portion) and beneficiaries designated by the decedent (the balance). The Tax Court found that the decedent held incidents of ownership in the policy and concluded that an amount equal to the insurance proceeds payable to the beneficiary designated by the decedent was includable in the decedent's estate under IRC Section 2042(2). The portion of the proceeds payable to the corporation would be reflected in the value of the corporation's stock, all of which was owned by the decedent and therefore includable in the decedent's estate under IRC Section 2031.

The Tax Court agrees that in the split dollar context, any incident of ownership (Q 81) possessed by a corporation is attributable to a sole or controlling stockholder.[3]

Letter Ruling 9348009 appears to conclude that an S corporation does not have incidents of ownership in insurance on the life of its owners held in a split dollar arrangement if the only interest the corporation has in the policy is to be reimbursed for its outlay for premiums paid. This conclusion appears to be inconsistent with the official position of the IRS and of courts that have addressed this issue. It may be, although the ruling does not say so, that the ruling concluded that because the owners were not controlling shareholders, incidents of ownership held by the corporation would not be attributed to the owners. The issues of whether a corporation holds incidents of ownership and whether an owner is treated as holding incidents of ownership held by the corporation ordinarily are treated as separate issues, however.

A later letter ruling involving a collateral assignment split dollar life insurance arrangement determined that a corporation would not be treated as holding incidents of ownership in a policy where the only right the corporation would hold would be, in essence, the right to be

1. 1982-2 CB 213.
2. TC Memo 1981-200.
3. Treas. Reg. §20.2042-1(c)(6). See *Est. of Dimen v. Comm.*, 72 TC 198 (1979), *aff'd without published opinion* (3rd Cir. 1980). See also *Est. of Carlstrom v. Comm.*, 76 TC 142 (1981), *acq.*, 1981-2 CB 1.

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reimbursed for premiums paid by the corporation. As a result, the life insurance proceeds would not be includable in a controlling shareholder's estate.

The importance of this ruling may have been undercut by its reliance on Rev. Rul. 76-274, which was later reversed by Rev. Rul. 82-145.[1] Nevertheless, several rulings since then have stated that a corporation or S corporation that has no interest in a collateral assignment split dollar arrangement other than to be reimbursed for its outlay for premiums paid does not hold incidents of ownership, an issue that need not be reached where there is no controlling shareholder.[2]

Any transfer by a corporate employer of incidents of ownership in a split dollar policy on the life of a controlling stockholder to an insured's transferee within three years of the insured's death is considered a transfer by the insured for purposes of the bringback rule of IRC Section 2035 (Q 91).[3]

In *Est. of Levy v. Comm.*,[4] dealing with estate taxation of split dollar life insurance, a corporation owned two split dollar policies on the life of a stockholder who owned 80.4 percent of the voting stock. The corporation owned all incidents of ownership except that it could not change the beneficiary, at least for any amount in excess of the cash value, without the approval of the insured's wife. The corporation was beneficiary of proceeds equal to the net cash value at death; the insured's widow was beneficiary of the excess proceeds. The executors of the insured's estate did not include any of the insurance proceeds in the estate because the insured at death did not directly hold any incidents of ownership in the policies. The IRS, in a deficiency notice, determined that the portion of policy proceeds payable to the insured's widow was includable in the estate. The Tax Court strongly supported the position of the government that the incidents of ownership held by the corporation were properly attributable to the insured. Moreover, the Tax Court indicated that had the deficiency notice called for inclusion in the estate of the entire proceeds rather than just the portion payable to the insured's widow, it would have supported the IRS. As it was, only the proceeds payable to the insured's widow were held includable in the insured's estate.

Gift Tax Issues

312. Does a life insurance funded buy-sell agreement fix the value of a business interest for gift tax purposes?

No.

A buy-sell agreement is not necessarily based on the fair market value of the business. A buy-sell agreement is simply an agreement between friendly parties to address the smooth transition of ownership due to a business owner's termination of employment, death, or sale of the individual's business interest.[5]

1. Let. Rul. 9511046.
2. Let. Ruls. 9651030, 9709027, 9746006, 9808024.
3. Let. Rul. 8252016.
4. 70 TC 873 (1978).
5. Effect of Purchase Price, Buy-Sell Agreements, and Key Person Insurance on Valuation, Gunnar J. Gitlin (Business Valuations in Divorce Cases – 2012), p. 63.

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An agreement restricting lifetime sale may be considered with all other pertinent factors, however, and may tend to lower the value of a close corporation or other business interest.[1]

On the other hand, failure to exercise rights under a buy-sell agreement could result in a taxable gift.

1. *Est. of James v. Comm.*, 148 F.2d 236 (2nd Cir. 1945); *Kline v. Comm.*, 130 F.2d 742 (3rd Cir. 1942); *Krauss v. U.S.*, 140 F.2d 510 (5th Cir. 1944); *Comm. v. McCann*, 146 F.2d 385 (2nd Cir. 1944), nonacq. 1943 CB 36; *Spitzer v. Comm.*, 153 F.2d 967 (8th Cir. 1946); Rev. Rul. 189, 1953-2 CB 294.

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