Key Executive Indemnification Insurance

# In General

Two markets for business life insurance are key executive (key person) indemnification and credit stability and standing. Many businesses will purchase an insurance policy for both credit and key executive indemnification purposes. This Subsection deals first with the indemnification motive and later with the credit motive for life insurance on a key executive.

# Key Executive Indemnification Insurance

Key executive insurance is insurance purchased by a business on the life of an owner or employee whose services contribute substantially to the success of the business. It is owned by and payable to the business. The insured owner or employee is a valuable asset that is insured by the firm in the same manner that its business building and equipment are insured against physical damage.

The insured is almost always someone who makes some substantial contribution toward the operation and the success of the business. This may be one of the owners of the business or a key employee. The key person’s death would mean that his or her services not only would be lost to the firm, but that his or her replacement probably would have less experience and be less well trained. The key person’s death is certain to disrupt the firm and probably will result in definite and tangible losses.

## The Human Factor in Business Success

The responsibility for the success of a proprietorship falls on its owner. In the small corporation or partnership, responsibility for the success of the business typically depends on a number of owners and employees who have significant responsibility each of whom may guide a particular phase of the firm’s operations. One person may be in sales management, a second in production, a third in finance, and a fourth in charge of the overall operation. The company depends on the unique talents of each individual. The importance of each person to the firm creates a need for indemnity against the loss that would result from a premature death.

Dun & Bradstreet, Inc. published a report that demonstrates the importance of the human factor in business. This analysis studied over 12,000 business failures, including not only businesses that merely discontinued operations but also businesses that ceased operations following assignment or bankruptcy; ceased with loss to creditors after execution, foreclosure, or attachment; voluntarily withdrew, leaving unpaid

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obligations; were involved in court actions such as receivership or reorganization; or voluntarily compromised with creditors out of court . For the year under study, the underlying causes of failure and the percentage of failures attributable to each cause were shown as follows:

|  |  |
| --- | --- |
| Incompetence | 48.5% |
| \*Unbalanced Experience | 20.2 |
| Lack of Managerial Experience | 15.1 |
| Lack of Experience in the Line | 8.7 |
| Neglect | 2.7 |
| Fraud | 1.4 |
| Disaster (Fire, Flood, etc.) | 1.3 |
| Reason Unknown | 2.1 |
| \*Experience not well rounded in sales, finance, purchasing, and production on the part of an individual in case of a proprietorship, or of two or more partners or officers constituting a management unit. | |

Of the seven known underlying causes of failure, six definitely involve human factors; only one was beyond the control of management. Even more significant is that 96.6 percent of the failures were attributed to these six causes.

This Dun & Bradstreet report illustrates that the human factor in business is responsible for nearly all business failures. The sales value of emphasizing the Dun & Bradstreet report is to stress the all-important fact that the human factor is the dominant and controlling factor in any business organization. Therefore, just as it must be held accountable for business failures, it must be given proper credit and recognition for business success.

The key assets of a business include its plant, equipment, and accounts receivable. However, these things are valuable only to the extent that the company has key people in key spots that can utilize them profitably. The critical asset of every business is the human life values of its key people.

The success or failure of the group business organization—the partnership, the LLC or the corporation—may hinge almost entirely upon the ability of the people in management. A business may continue after the death of key personnel, but its success depends upon its management, and the death of even one member of the management team may turn success into failure—however capable remaining management may be.

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Every business has one or more owners or employees whose peculiar talents, experiences and ability are integral to the success of the business—they are "the brains behind the business"; the business would suffer a material loss from their death. There would be an immediate loss of profits and further losses inherent in securing and training this key person’s successor. This loss to the business is the loss of a management asset—just as a building fire results in a loss of a physical asset. In the same manner that fire insurance protects against a physical loss of plant, inventory or equipment, life insurance will protect the business against the loss of its management asset—the destruction of its human life value.

The main purpose of life insurance is to offset the economic loss that comes with death—to offset the human value that disappears with death. We are aware from our other insurance field experiences how life insurance acts to indemnify a family for the loss of an income-earning parent. The key executive story is a similar protection story. Only in this case the business is being protected against loss.

## Insuring Property vs. Insuring Life

Business people accept without question the wisdom of insuring the firm against the loss of its property. They take care to insure the physical assets against loss from fire, tornadoes and other hazards. Yet, protection against the loss of human life—life insurance on the key executive—may be a far more vital need.

In the first place, the probability of loss is considerably greater. It has been estimated that the chance of death of a key executive is many times greater at age 45 or older than the chance of a fire loss.

Moreover, a fire loss may never occur, but death is inevitable. While most buildings never burn, and most insured goods are never damaged by fire, about one out of every four people die during their working years. Furthermore, the average fire loss probably does not exceed 10 percent of the property value insured, while the death loss is always complete.

In the second place, the loss of a key person through death is likely to be more permanent for the business. The plant that is destroyed by fire can be rebuilt. Moreover, the new building will be an improvement over the old one—more efficient, more sound, representing the latest in engineering developments. The new building is likely to be more useful and valuable than the old.

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Can we say the same for the new manager? The executive who died may have had a talent or ability that is tremendously difficult to reproduce in the new replacement. In fact, the deceased key person may be impossible to replace. In most cases, he or she can be replaced; however, until the new person is found and becomes familiar with the duties and problems of the job, he or she will be less useful to the business.

## Cash Value of Services Lost

Life insurance cannot replace the mind that has been lost to the business when death strikes. But life insurance indemnifies the business for the approximate cash value of the services that will be lost—so far as those human life values can be measured.

Life insurance can provide the business with CASH—

* Cash to keep the business running,
* Cash to assure the creditors that their loans are safe,
* Cash to assure customers that the business will continue operations,
* Cash to cover the mistakes and errors that the deceased’s successor will make until he or she learns the things the deceased knew from experience,
* Cash to cover the losses involved in a less capable successor’s mistaken decisions,
* Cash to cover the special expenses of finding, securing and training a new person to take the deceased’s place,
* Cash available for many uses which cannot be determined in advance because those uses will depend upon the particular circumstances of that particular business at that particular time.
* Cash may prove invaluable at a time when the control and management of the business or of some major department of the business is in the inevitable process of change and restructuring following the death of a key executive or a valued employee.

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The business has only to carry life insurance on this key executive, payable to the firm, to indemnify itself for the loss when it occurs. The business thus protects itself against financial reverses that will result from the loss of a key employee through death. Today, the business can be made aware of the importance of this key executive to its success, and the business can act today to protect its management asset with key executive life insurance.

Premiums paid by a corporation on a policy, which it owns, or in which it is the beneficiary, are not deductible for income tax purposes. Prospects may claim that this is a disadvantage of life insurance. Such a view is shortsighted. Life insurance contracts normally bring substantial tax advantages in the form of yearly nontaxable increases in cash value and in the fact that lump sum death proceeds will be received entirely free of tax.

## Insurable Interest

A corporation or other business has an insurable interest in the life of any executive or employee actively associated with the firm whose death would cause it tangible loss. The corporation certainly can insure itself against the loss of its earning power that would be caused by the death of an executive who has materially increased its profits through his or her initiative, ability, and energy.

Likewise, a corporation has an insurable interest in the life of a stockholder who owns a large portion of the corporate stock, and whose skill and experience are relied on to a great extent to continue the business successfully.

# Mechanics of the Plan

No particular form of agreement is needed by the business to carry key executive life insurance. However, the Board of Directors should authorize the maintenance of the insurance and the payment of the premiums. A suggested sample resolution for this purpose appears below.

BOARD RESOLUTION AUTHORIZING KEY EXECUTIVE INSURANCE

RECITALS

(1) \_\_\_\_\_\_\_\_\_ (Key Executive) is now and for many years has been the President of the Corporation, and by reason of his or her unusual ability as its chief executive officer, it has consistently earned profits for the stockholders well above the average for the industry.

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(2) The termination of the services of\_\_\_\_\_\_\_ (Key Executive) by reason of his or her death would result in the loss of his or her managerial skill, experience and profit-making ability to the Corporation.

(3) The Corporation desires to make secure its financial position in the event of the death of\_\_\_\_\_\_\_\_\_\_ (Key Executive), and to indemnify itself against losses to its earning power which his or her death would occasion.

RESOLUTION

THEREFORE, IT IS RESOLVED; That the\_\_\_\_\_\_\_\_\_ (officer) be authorized and instructed to secure a policy or policies of life insurance in the \_\_\_\_\_\_\_ (company or companies) on the life of\_\_\_\_\_\_ (Key Executive), having a total face value of $\_\_\_\_\_\_, with the Corporation to be named beneficiary of the policy or policies and to be owner of same; the policies so obtained shall be of the\_\_\_\_\_\_ type. The Treasurer is instructed to pay all premiums on such policy or policies as they become due.

New York: Defines "Key Executive" for Life Insurance Policies

As discussed above, an important question for states is how to regulate corporate-owned life insurance (COLI) so as to prohibit abuses while permitting legitimate business uses such as key executive insurance. The solution has generally been to adopt individual statutes or regulations covering specific purposes for a COLI policy. For example, as noted, many states including New York permit COLI as a means of financing employee benefit packages, by statute. As for janitor insurance, states are choosing to curb it by defining key executive insurance by statute or regulation. Regulation 180 defines "key executive" for the purposes of life insurance policies sold in New York:

Under Section 3205(a)(1)(B) [of the Insurance Law], an employer has an insurable interest in the lives of certain employees and other persons, commonly referred to as "key employees" or "key persons", whose services and qualifications are of such nature that their death or disability would cause the employer to incur a substantial pecuniary loss ... The purpose of ... [Regulation 180] is to establish standards for life insurers and fraternal benefit societies issuing key person company-owned life insurance to ensure that the employees or other persons on whose lives coverage is being written pursuant to Section 3205(a)(1)(B) of the Insurance Law are actually key persons.

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Regulation 180, N.Y.C.R.R. §48.0(c)-(d). This is a simple, clear introduction to simple, clear standards, as follows:

For purposes of ... establishing whether there exists an insurable interest under Section 3205(a)(1)(B) at the time the policy is issued, the term *key person* shall include the following persons:

(a) An employee who is one of the five highest paid officers of the employer;

(b) An employee who is a five-percent owner of the employer. A "five-percent owner" shall mean:

(1) If the employer is a corporation, any person who owns or controls more than five percent of the outstanding stock of the corporation or stock possessing more than five percent of the total combined voting power of all stock of the corporation; or combined voting power of all stock of the corporation; or

(2) If the employer is not a corporation, any person who owns more than five percent of the capital or profits interest in the employer;

(c) An employee who had compensation from the employer in excess of $90,000 in the preceding year;

(d) An employee who is among the highest paid 35 percent of all employees; or

(e) An employee or other person who makes a significant economic contribution to the company, including but not limited to, an employee who is responsible for management decisions, has a significant impact on sales or a special rapport with customers and creditors, possesses special skills, or would be difficult to replace. Criteria for the employer’s determination shall be included in the insurer’s underwriting guidelines.

This definition is not novel. Sections (a)-(d) are essentially taken over wholesale from that proposed by Congress in the COLI Best Practices Act of 2005 (in committee; to be codified at IRC Section 101(j)). The only difference is that the regulation spells out what in the proposed federal statute are cross-references to the Internal Revenue Code (thus the reference to $90,000 in subsection (c) reflects the definition of "highly compensated employee in IRC Section 414(q)).

Thus, four of the measures for being a key person in New York are clear and quantitative. The fifth, constituting the criteria contained in subsection (e), is more intuitive and subjective, but it is scarcely impossible to apply. It may not capture every employee who is crucial to the business, or exclude every member of the rank and file, but it is a good start.

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# Termination of the Key Executive

In most states the firm has a legal right to continue to pay the premiums and receive the death proceeds of a key executive insurance policy after the key executive has terminated his or her employment. The question of insurable interest arises only at the beginning—when the insurance policy is purchased—despite the later termination of the insured’s employment.

Although it is legally permissible, the question remains whether a firm should maintain a policy on the life of a former employee. The answer depends on the individual circumstances. In most cases, it would seem best to either terminate the insurance or sell the policy to the insured. The business can then purchase a policy on the life of the insured’s successor. Some companies have developed policies with so-called "exchange of insured" options, which permit a change in the insured, with appropriate premium adjustments, to avoid new acquisition costs. [Note that the IRS treats the exercise of an "exchange of an insured" option as a sale not a tax-free exchange under IRC Section 1035. Rev. Rul. 90-109, 1990-2 CB 191].

# The Insurance Policy

The business should be the applicant, premium payer, owner, and beneficiary of the policy. An officer of the business other than the insured signs the application. The key person will also sign the application as "proposed insured" to affirm the personal data on the application.

All premiums should be paid by the applicant—the business.

The business will own the policy and possess all incidents of ownership.

The business will be the beneficiary, since it is purchasing the policy for its own benefit.

Proper designation of the employer as policyowner and beneficiary is important. In one case, for example, a company paid all premiums for a policy that was intended to indemnify it against the death of a key employee. But the employee was listed as the the policyowner and his wife was named as beneficiary, and when the decedent died, both the wife and the employer claimed the proceeds. The employer claimed an equitable right to the proceeds because of the key employee rationale for the policy, even though the wife was the designated beneficiary.

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The court found that there had been no fraud involved in the beneficiary designation, and that the employer failed to show a proper equitable claim for the proceeds. Therefore, the wife was awarded the proceeds. *Guarantee Reserve Life Ins. Co. v. Hardin and World Market Centers, Inc.*, 404 F.Supp. 961 (U.S.D.C. Okla. 1976).

The type of policy used should be one that best suits the needs of the firm. The policy may include a waiver of premium provision, to relieve the firm of premium payments if the executive becomes disabled.

It would be advantageous for the firm to retain the insurance policy on the executive’s life after he or she becomes disabled. If the executive recovers enough to return to work, he or she may have lost his or her insurability.

Moreover, during the period of disability, the money formerly paid out in insurance premiums could be directed toward the payment of sick pay for the insured key person. Since sick pay is deductible by an employer, if reasonable in amount, the payment to the disabled key executive could be larger than the amount of the waived insurance premiums, without the business assuming a larger net after tax outlay. For example, if the annual premium outlay had been $3,500, a corporation in the 34 percent bracket could pay a disability benefit of $5,300 for the same after-tax outlay. A similar justification could be made for the payment of an enforced early retirement benefit, should disability prevent the key executive from returning to work.

# Determining the Amount of Insurance

The key person’s employer often has a difficult time deciding the amount of insurance it should purchase on his or her life. The employer is dealing with human life values, not property values, so no set formula or rule can be used. Therefore, in many key executive insurance cases, the amount of insurance will be established in a somewhat arbitrary manner.

There are, however, a few points that might be considered in reaching a reasonable figure.

1. How much would it cost to replace the employee? The person is valuable to the business. A new person will have to be hired to take his or her place. Will the new employee demand more salary? Would the new employee do the job as well? How long would it take to train the new employee to reach the proficiency level of this key employee? How much will the company need to spend in finding and training a capable successor?

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2. How much is this employee worth to the firm in net profits? The executive is making a definite contribution to the firm’s success and is accountable for some proportion of its profits. In many cases, it may not be difficult to apportion the profits that can be credited to his or her efforts. For example, this apportionment would not be difficult in the case of a good salesperson. His or her sales records provide a definite "yardstick." In other cases, it might be difficult to relate the employee’s performance to profits. The worth of the company treasurer, for instance, would be hard to measure in this way.

3. How much would it cost the business if this employee died today? The answer to this question turns on how difficult it would be to replace the special talents of the key executive. Would the company collapse? Would a special project have to be abandoned, or a department closed, if this employee died?

4. What proportion of the company’s actual loss is it willing to insure? The company’s desire to insure completely against the loss of the key employee may be limited by working capital or cash flow considerations.

# Valuing the Key Executive—Specific Methods

A number of methods have been used or suggested for valuing the key executive. Three of these methods are: (1) an adoption of the human life value approach, (2) measuring management’s contribution to earnings, and (3) the salary test.

Adoption of the Human Life Value Approach

This method is a takeoff on the method commonly used to reach the value of a person to his or her family. This value is arrived at by:

* Estimating the person’s average annual earnings over his or her working life.
* Deducting federal and state income taxes and the cost of maintaining the person.
* Determining the person’s life expectancy or the number of years to retirement, whichever is shorter.
* Selecting a reasonable rate of interest at which future earnings will be discounted.
* Multiplying (1) minus (2) by the present value of $1 per annum for the period determined in (3), discounted at the rate of interest selected in (4).

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The product is the human life value. A key executive would be valued in a similar fashion. For example, a key executive, age 55, has at least ten years of active service remaining with his or her employer. The company estimates that its loss of earnings if he or she died today would amount to $30,000 annually. Over a ten-year period the loss would be $300,000. If we discount the value of $30,000 annually for ten years, using a 10 percent present value factor, we arrive at the present value of the key executive’s services of $113,067. If there were other persons in the company capable of taking up the slack caused by this executive’s demise, then the amount of key executive life insurance could be reduced accordingly.

Management’s Contribution to Earnings

This computation is based upon two financial figures—the average book value or stockholders’ equity of the company for the past five years and the average net income before taxes for the same period.

... The average book value is multiplied by some percentage that represents a fair return, if the money were invested elsewhere by the owners.

... The product then is subtracted from the average five-years’ income to obtain that portion of business income attributable to management.

... The difference then should be multiplied by the number of years it would take to find and train new management. This product represents the value of the management which could be indemnified with the proper life insurance.

As an example, let us suppose that a firm has an average book value of $450,000, and an average income before taxes of $75,000. Further, it considers 10 percent to be a fair return and estimates that it might take four years to replace the current management. The steps in computing "management value" are:

* Average book value times fair return equals investment elsewhere. $450,000 × 10% = $45,000
* Average income minus fair return equals management portion: $75,000 - $45,000 = $30,000
* Management portion times replacement years equals management value: $30,000 × 4 = $120,000

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A further computation would have to be made to divide the management value among the members of the management group. The result would be the value of the individual members of the management group.

The Salary Test

To use this method, first determine the salary of the key executive in excess of what would be paid if someone else were hired to do his or her routine duties. This "excess" salary then is multiplied by the number of years it would take to find and train a replacement.

Example: if the executive in the previous illustration was being paid $32,000 per year and a replacement to perform his or her routine duties could be found for $15,000, then the key person’s executive talents are worth $17,000. Multiplied by four replacement years, the key executive is worth $68,000.

Key Person Valuation Illustrations

This section illustrates the three commonly accepted methods of key person valuation discussed above.

(1) Contribution to Total Earnings

Difference between the interest produced by the company’s average net worth for the last five years and the average annual profits. This figure is assumed to equal annual earnings attributable to management, which is multiplied by the percentage of all key persons’ salaries represented by the individual key person’s salary. The resulting figure for annual earnings attributable to the key employee is multiplied by the estimated number of years needed for replacing the key employee.

(2) Cost to Replace Key Employee’s Experience

Difference between the key person’s annual salary and the portion of that salary estimated to be compensation for the performance of routine duties. The resulting figure is assumed to represent the annual salary paid for the key person’s expertise, which is multiplied by the estimated number of years needed for replacing him or her.

(3) Capitalization of Salary

The key employee’s annual salary multiplied by a capitalization factor. This factor is assumed to reflect the value of the key person indicated by, but not included in, the annual salary.

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| --- | --- |
| Key Person Valuation | |
| Prospect Company | |
| **Contribution to Total Earnings Method** | |
| Average Pre-Tax Annual Profits Last 5 Years | 466,000 |
| Less Rate of Return on Avg Book Value Last 5 Years (12% x 1485000) | 178,200 |
| Equals Annual Earnings Attributable to Management | 287,800 |
| Times Percent Earnings Attributable to Prospect  (Prospect Ann Salary / Tot Ann Sal All Key Pers = 125,000/400,000) | x    0.31 |
| Equals Annual Earnings Attributable to Prospect | 89,218 |
| Times Years Needed to Fully Replace Prospect | x    5 |
| **TOTAL VALUATION** | 446,090 |
| **Cost to Replace Prospect’s Experience Method** |  |
| Prospect’s Annul Salary | 125,000 |
| Less Annual Salary to Perform Routine Duties | 5,000 |
| Equals Annual Salary for Prospects Expertise | 80,000 |
| Times Years Needed to Fully Replace Prospect | x    5 |
| **TOTAL VALUATION** | 400,000 |
| **Capitalization of Salary Method** |  |
| Prospect’s Annual Salary | 125,000 |
| Times Salary Capitalization Factor | x    3 |
| **TOTAL VALUATION** | 375,000 |

As illustrated, the Contribution to Total Earnings method calculates the Annual Earnings Attributable to the Prospect by multiplying the Annual Earnings Attributable to Management by the ratio of the Prospect’s Annual Salary over the Total Annual Salaries of all Key Persons. The resulting figure is then multiplied by the Years Needed to Fully Replace the Prospect. In our sample report, this gives a total valuation figure of $446,090.

The Cost to Replace Prospect’s Experience method subtracts the annual salary it would cost the business to hire someone to perform the key person’s routine business functions from the Prospect’s Annual Salary. The difference represents the annual salary paid for the key person’s expertise. This difference is then multiplied by the Years Needed to Fully Replace the Prospect. This amount, in our sample report, is $400,000.

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The final method used is the Capitalization of Salary method which measures the key person’s value to the business by multiplying his or her Annual Salary by a Capitalization Factor (3 in our sample report). This method recognizes that the key person’s annual salary does not, in and of itself, represent the key person’s entire value to the company. The intelligence and skill of the key person necessarily are not accurately reflected by salary alone. Our example of the Capitalization of Salary method assigns a total valuation of $375,000 to the key person.

This illustration uses a replacement period of five years and a salary capitalization factor of three. The Contribution to Total Earnings method yields the highest valuation figure because of a sizable surplus of earnings over average return on book value, as well as the substantial time period anticipated for replacing the key person. In all cases, the valuation is at least three times the key person’s actual salary.

The use of all three methods of key person valuation gives your business prospect a realistic range of dollar amounts with which to measure an individual key employee’s value to the company. The proper amount of key person life insurance coverage can keep the business running, cover the expenses of finding and training a new employee to take the deceased’s place, and cover any losses resulting from a replacement’s lack of experience during the period of time the new employee is acclimating him or herself to the requirements of the particular business situation.

# Income Taxation

There are three basic issues involved:

* Are the premiums deductible?
* Is the insured executive currently taxed on the employer’s premium?
* Are the proceeds subject to the federal income tax?

In the properly structured key executive insurance situation, where the employer is the policyowner, premium payer and beneficiary, the answer to all of the above questions is "No."

# Non-Deductibility of Premiums

Key executive life insurance premiums are not deductible because the firm is directly or indirectly a beneficiary under the policy. The Internal Revenue Code states: "No deduction shall be allowed for—(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or

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business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy." IRC Sec. 264(a)(1).

Agreement by Corporation to Pay to Certain Individuals

Where the corporation is beneficiary of the insurance policy, the premiums it pays are not deductible, notwithstanding that the corporation (by a separate agreement) has contracted to pay the proceeds to the beneficiaries named by the insured if he or she continues in the corporation’s service. *Omaha Elevator Co*., 6 B.T.A. 817; G.C.M. 7997, IX-1 C.B. 210; IRC Sec. 264(a)(1). But the payment by the corporation of the proceeds to the named beneficiary pursuant to the separate agreement will be deductible by the corporation. *Seavey &* *Flarsheim Co*., 41 B.T.A. 198; *Bleichroeder, Bing & Co*., Inc., 12 T.C.M. 117.

Salary Increases to Meet Premiums on a Corporation’s Policy

In some cases, a corporation may attempt to circumvent this general rule by increasing the salary of an officer or employee with the understanding that the increase is to be used to pay premiums on a policy in favor of the corporation. Then the corporation claims an income tax deduction in the amount of the entire salary paid the insured, including that used by the insured to pay the premiums on the policy. However, the corporation may not deduct the portion of so-called compensation used to pay the premiums. *Esdorn Lumber Co. v. Comm’r*, B.T.A.M. (P-H) P 33,137 (1933).

Sole Proprietor and Partnership Arrangements

If an employee insures the life of a sole proprietor and is also the beneficiary of the policy, the employee may not deduct the premiums. IRC Sec. 262; *James G. Whitaker*, 34 T.C. 106 (1960). Further, the premiums paid by a sole proprietor for insurance on his or her own life are considered nondeductible personal expenditures whether the proceeds are payable to the estate or to a personal beneficiary. IRC Sec. 262.

Where insurance is purchased on the life of a partner, and the premiums are paid either by the partnership or a co-partner, the premiums are nondeductible, regardless of who the beneficiary is. Treas. Reg. §1.264-1(b); *Clarence W. McKay*, 10 B.T.A. 949; *Alexander C. Yarnall*, 9 T.C. 616, aff’d 170 F.2d 272 (1948). The premiums are not deductible even when each partner pays for the insurance on his or her own life and the proceeds are designated irrevocably to be paid to a co-partner. *Joseph Nussbaum*, 19 B.T.A. 868; Rev. Rul. 73, 1953-1 C.B. 63. In both cases the arrangement makes each partner an indirect beneficiary of the policy within the meaning of Code Section 264.

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Premiums Paid by Corporation as Debtor

Where a corporation pays premiums on a policy in favor of a creditor in order to procure a loan and as security therefore, the premiums are not deductible. The premiums are nondeductible even though the insured-debtor was required to secure and maintain the policy in order to obtain the loan. IRC Sec. 264(a)(1); *Jefferson v. Helvering*, 121 F.2d 16, *Klevin v. Comm.*, 84 F.2d 310, *Rieck v. Heiner*, 25 F.2d 453; *Peerless Pattern Co.*, 29 B.T.A. 767. Further, if premiums are paid by a corporation as additional compensation to the insured with the insured’s spouse designated as beneficiary, the premiums are nondeductible where the insured and beneficiary assign the policies as collateral to secure a corporate loan. *Favorite Panama Hat Company*, 2 T.C.M. 231 (1943). In these and similar cases the corporation is indirectly a beneficiary under the statute since the proceeds of the policies would be applied to the corporate debt.

However, when the corporation uses the personal insurance of an officer as collateral for its bank debt and pays the officer a fee for such use, the fee has been held a deductible business expense if it was reasonable in amount, even though the amount coincides with the amount of the policy premium. *D.B. Thornton*, 4 T.C.M. 29 (1945).

# Premiums as Taxable Income to the Insured

If the key executive insurance policy is purchased in the proper manner—the corporation as the owner and beneficiary—the insurance premiums paid by the corporation will not be taxed as additional income to the insured employee even if the insured is a controlling stockholder of the corporation. *Casale v. Comm.*, 247 F.2d 440 (1957), rev’g 26 T.C. 1020; Rev. Rul. 59-184, 1959-1 C.B. 65. The insurance premiums are taxable income to the insured employee only where (1) the employee has the right to name the beneficiary or (2) the proceeds of the policy directly benefit the employee, his or her dependents, or estate. In these instances, the view is that the corporation merely pays the premiums for the employee. Treas. Reg. §1.61-2(d)(2); *Yuengling v. Comm.*, 69 F.2d 971; *Canaday v. Guitteau*, 86 F.2d 303 (1936); *George Matthew Adams*, 18 B.T.A. 381 (1929); *N. Loring Danforth*, 18 B.T.A. 1221 (1930); *William T. Pettit*, 19 T.C.M. 679 (1960). This is true even though the employer may not be able to deduct the premiums because they, plus the employee’s salary, exceed reasonable compensation. Treas. Reg. §1.162-8. If dividends are applied to reduce current premiums, only the net premiums are taxed to the employee. *C. Francis Weeks*, 16 T.C. 248 (1951).

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Premiums are also taxable to the insured where the employer irrevocably names the insured’s family as beneficiaries (*Comm. v. Bonwit*, supra.) or where the beneficiary is a trustee who holds the policies for the benefit of the insured’s wife and children. *Yuengling v. Comm.*, supra; *Canaday v. Guitteau*, supra.

Premiums Held Taxable as Dividends

If premiums paid by a corporation are considered a distribution of dividends, the corporation cannot take a corresponding tax deduction. The corporation can take a deduction only where the premiums paid constitute salary or compensation and are then deductible as a business expense.

A corporation owned key executive insurance on two of its stockholders. Although continuing to pay the premiums, it assigned the policies to the respective stockholder-insureds, who named members of their families as beneficiaries. Premiums paid by the corporation were charged to general expenses until the Commissioner assessed a deficiency against the shareholders on the ground that the premiums paid were, in effect, distributions of dividends; then the premiums were charged to the drawing accounts of the shareholders. The taxpayers contended that the premium payments were loans to them, and not distributions of profits. However, the Board of Tax Appeals held that since the premiums had been charged all along to general expenses and the shareholders could show no security given for the "loans," the premium payments by the corporation amounted to taxable dividend distributions. *Earl Everett Jameson,* B.T.A.M. (P-H) P 42,042.

In another case, premiums paid by a holding company for a $250,000 policy, insuring the life of a stockholder and naming the stockholder’s family as the beneficiary, were held taxable as distributions of dividends. The two shareholders had entered into a stock option agreement whereby upon the insured’s death the other stockholder could buy the decedent’s stock at a price of $125,000 less than would have been the price without the insurance. Thus, both stockholders benefited from the premiums. The insured-stockholder benefited since, at death, the surviving family would receive one-half the proceeds as personal insurance. The other stockholder benefited because the other half of the proceeds would be received by the insured’s family in lieu of $125,000 cash which, in the absence of the insurance, the other stockholder would have to pay as part of the purchase price for the insured’s stock. *Paramount-Richards Theatres v. Comm.*, 153 F.2d 602 (1946).

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In *Casper Ranger Construction Co.* (1 B.T.A. 942 (1925)), the corporation carried insurance on the lives of its three shareholders, but was not named beneficiary in any of the policies. The corporation’s premium payments were held taxable dividends to the shareholders.

Premiums Held Not Taxable as Dividends

In a rather unusual case, a corporation purchased two single-premium life policies insuring the manager/sole stockholder of the corporation. The entire corporate surplus was used to pay the premium. The beneficiary was the stockholders son, his sole heir, but the insured reserved the right to change the beneficiary. The policies had already been surrendered for cash value, and the proceeds returned to the corporate treasury, when the deficiency was assessed against the stockholder. The court held that this was not a taxable distribution of dividends, since the taxpayer, "did not receive for himself a single dollar" and the evidence showed that the policies were always treated as a corporate asset, available to creditors. *Lewis v. O’Malley*, 140 F.2d 735 (1944).