Business Life Insurance

# Key Person Life Insurance

Key Person Insurance Owned by a Corporation

A corporation purchases key person insurance for its own benefit; that is, to indemnify the business against financial loss from the premature death of the key person. Consequently the only logical arrangement for the insurance is to make the corporation both owner and beneficiary of the policy.

The life insurance proceeds in such a case are not normally includable in the insured’s gross estate. There is no basis for taxing the proceeds in the insured’s estate if the proceeds are not payable to his estate and he has no incidents of ownership in the policy. IRC Sec. 2042.

The Internal Revenue Service is, however, quite resourceful in finding incidents of ownership in unexpected places. For example, in Rev. Rul. 79-46, 1979-1 CB 303, a corporation owned insurance on the life of a key person. As part of the employment contract, the parties agreed that if at any time the corporation decided to discontinue the insurance, the insurance would not be terminated until the insured had been given a chance to purchase the policy from the corporation for its cash surrender value. The insured died possessing this conditional purchase right. The Service held that such right was an incident of ownership in the policy and that the amount includable in the insured’s estate was the amount of the proceeds reduced by the cash surrender value at death (the amount the insured would have had to pay the corporation for the policy had he been given the opportunity to exercise his purchase option immediately before he died).

On substantially the same facts as those present in Rev. Rul. 79-46, above, the Tax Court held that the insured’s contingent purchase option, as described therein, was not an incident of ownership within the meaning of IRC Section 2042. *Est. of Smith v. Comm.*, 73 TC 307 (1979), acq. in result, 1981-1 CB 2. (In both cases the corporation (insured’s employer) owned all ownership rights including the right to change the beneficiary; but in Rev. Rul. 79-46 the beneficiary was the insured’s spouse, while in *Smith*the beneficiary was the corporation.)

In *Est. of Morrow*, 19 TC 1068 (1953), acq. 1954-1 CB 5, nonacq. 1979-2 CB 2, the employer corporation owned $10,000 of insurance on the life of the decedent, its purchasing agent, pursuant to a plan of insurance for employees. The corporation paid the premiums (for which it claimed no income tax deduction) and was the sole beneficiary. When the insurance was

Business Life Insurance

acquired, the corporation wrote to the decedent that it was the “purpose of the Company in the event of your death to pay one-half of the proceeds of the insurance to your family.” Decedent was asked to designate his beneficiary, restricted to “a member or members of your immediate family.” The decedent designated his wife, later changed to his daughter after his wife’s death. When decedent died, the proceeds were paid to the corporation, which deposited the proceeds to its bank account and thereafter paid $5,000 to decedent’s daughter.

The Commissioner claimed that the decedent’s right to designate a beneficiary of the amount the company intended to pay to his family was tantamount to a right to designate a beneficiary of the insurance itself and as such amounted to an incident of ownership, thereby bringing $5,000 of the proceeds into his estate. The Tax Court rejected the Commissioner’s argument: “The wife and daughter were merely the persons to whom the employer proposed to pay $5,000 after it had received the entire proceeds of the policy from the insurer. The persons designated by the decedent were not to receive insurance as such but were to receive something from [the corporation]. The situation would be entirely different if the insurance policy had named [the corporation] as beneficiary to the extent of $5,000 and the wife or the daughter as beneficiary to the extent of the remaining $5,000…. If the letter and the surrounding circumstances constituted a binding contract between [the corporation] and the decedent or the member of his family designated by him, nevertheless, that was not a contract of insurance, and since section 811(g) [now 2042] applies only to the proceeds of life insurance, it does not cover the present situation.”

Interestingly, the letter from the corporation to the decedent describing the insurance plan said that if the decedent should leave the company or if the company should decide to discontinue the insurance, he would be entitled to purchase the policy from the company at its cash surrender value. The IRS did not, however, argue on that occasion, as it has since held, that the purchase option constituted an incident of ownership.

Occasionally a corporation purchases a key person policy to indemnify the business but the terms of the policy give the insured certain incidents of ownership. Usually, in such a case, possession of incidents of ownership by the insured is inadvertent. Regardless of the intention of the parties, however, the courts have held almost without exception that the terms of the policy control. Thus, the *entire* proceeds are includable in insured’s estate under IRC Section 2042(2). *Est. of Piggott v. Comm.*, 340 F.2d 829 (6th Cir., 1965); *Hall v. Wheeler*, 174 F. Supp. 418 (D. Me. 1959); *Kearns v. U.S.*, 399 F.2d 226 (Ct. Cls., 1968); *Cockrill v. O’Hara*, 302 F. Supp. 1365 (M.D. Tenn. 1969).

Business Life Insurance

In the *Kearns* case, supra, the insured apparently intended the policies to belong to his family’s corporation; however, the terms of the policies granted certain rights to the insured, including the right to change the beneficiary. Evidence showed that all premiums were paid by the corporation, the policies were carried as an asset on the corporation’s books and financial statements, and at all times the policies were in the physical custody of the corporation. Nevertheless, the court held that the entire proceeds were includable in the insured’s gross estate. The court said:

“Thus, this court is called upon to decide whether the facts indicating decedent’s intentions are sufficient to overcome the facts set forth in the contracts themselves. In light of the Supreme Court’s holding in *Comm. v. Est. of Noel*, 380 U.S. 678 (1965), the policy facts would appear to be controlling. Since decedent retained significant rights under the policies, it is found that he did, at his death, possess incidents of ownership in these policies rendering them includable in his gross estate pursuant to section 2042(2).”

Insurance on Controlling Stockholders

Special rules apply where a corporation owns insurance on the life of a controlling stockholder if the proceeds, or any part of them, are payable other than to or for the benefit of the corporation. These rules are set forth in Treas. Reg. §20.2042-1(c)(6).

In general, these rules provide that to the extent proceeds of insurance owned by a corporation on the life of a “controlling stockholder” 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 such proceeds will be attributed to the insured.

If, for example, a corporation owns a policy of insurance on the life of its majority stockholder, and the proceeds are payable to the insured’s wife, upon the insured’s death (assuming he is still majority stockholder at that time and the proceeds are still payable to his wife), the insured will be considered to have owned the policy at his death and the proceeds will consequently be included in his gross estate under section 2042(2) of the Code. *Est. of Horne*, 64 TC 1020 (1975), acq. in result, 1980-1 CB 1; *Est. of Levy v. Comm.*, 70 TC 873 (1978).

If, in the previous example, the proceeds were payable to the corporation, or to someone else for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of the proceeds, there would be no attribution of incidents of ownership, and the tax results would be the same as if the insured were not a stockholder.

Business Life Insurance

If, in the previous example, the policy proceeds had been payable 40% to the insured’s spouse and 60% to the corporation, only 40% of the proceeds would be included in the insured’s gross estate under IRC Section 2042. In Rev. Rul. 82-141, 1982-2 CB 209, X corporation owned insurance on the life of its controlling stockholder, D. The corporation assigned all its incidents of ownership in the policy to A. D died in 1981 within three years of the assignment and the proceeds of the policy were paid to A. The Service held that the proceeds were includable in D’s estate under IRC Section 2035 by reason of attribution to D of the incidents of ownership held by the corporation. The ruling failed to state who was beneficiary under the policy before the assignment.

In TAM 8806004, life insurance owned by a corporation on its majority shareholder was included in the shareholder’s estate where the corporation sold the life insurance policy to a third party within three years of the shareholder’s death. Consideration equal to the reserve value of the policy was considered inadequate to avoid the transfers within three years of death rule. However, in Letter Ruling 8906002, life insurance owned by a corporation on its majority shareholder and payable to the corporation was not included in the majority shareholder’s estate where the shareholder sold her interest in the corporation within three years of her death.

In situation 1 of Rev. Rul. 90-21, 1990-1 CB 172, a corporation transferred a policy insuring the controlling stockholder within three years of such shareholder’s death, but the shareholder disposed of his voting stock after the transfer of the policy and prior to his death. The Service held that the incidents of ownership held by the corporation were attributable to the controlling shareholder at the time of the transfer of the policy. The controlling shareholder was considered to have transferred the incidents of ownership within three years of his death and the proceeds were included in his estate.

In situation 2 of Rev. Rul. 90-21, 1990–1 CB 172, the corporation didn’t transfer ownership of the policy, but the controlling shareholder transferred enough voting stock to eliminate his control of the corporation within three years of his death. The Service held that the incidents of ownership held by the corporation were attributable to such shareholder while he was the controlling shareholder. When the shareholder ceased to be controlling shareholder, he released the incidents of ownership attributable to himself as controlling shareholder. Such release was considered a transfer made within three years of the shareholder’s death and the proceeds were included in his estate.

Although policy proceeds of corporation owned insurance on the life of a stockholder, if payable to or for the benefit of the corporation, will not be included, as such, in the insured’s estate, the proceeds will be considered in determining the value of the insured’s stock in the corporation. Treas. Reg. §20.2031-2(f).

Business Life Insurance

A “controlling stockholder” means one who owns stock possessing more than 50% of the total combined voting power of the corporation. For this purpose, a decedent is considered owner only of stock with respect to which title was held at the time of his death –

1. by the decedent (or by his agent or nominee);

2. by the decedent and another person jointly, and for the purpose of determining the proportion of the decedent’s ownership interest, the estate tax rules as to jointly held property explained at "Joint Interests" apply; and

3. by a trustee of a voting trust (to the extent of the decedent’s beneficial interest therein) or any other trust as to which the decedent, at the time of his death, was treated as owner for income tax purposes under IRC Sections 671 to 678.

Since a “controlling stockholder” is defined as one who owns *more than 50%* of the voting stock of the corporation, it is apparent that where such stock is community property, the special rules do not apply. In such a case, the stockholder-insured and his spouse are each deemed to own one-half the stock (even though title may be held in the name of only one spouse); therefore, the insured spouse cannot be a “controlling stockholder” within the definition even if he nominally owns all the stock. See, also, *3 Journal of Corporate Taxation* 268 (Autumn 1974), fn. 53. (For the location of more information on community property, see the entry “Community property” in the Index.)

Effect of Proceeds on Value of Insured’s Stock

If the key person is a stockholder, the insurance proceeds will be considered as a corporate asset in valuing his stock for estate tax purposes. Consequently, his gross estate will reflect a share of the proceeds proportionate to his stock ownership. *Est. of Blair*, 4 BTA 959 (1926); *Est. of Doerken*, 46 BTA 809 (1942); *In re Patton’s Will*, 278 N.W. 866 (Wisc. 1938); *In re Reed’s Est.*, 153 N.E. 47 (N.Y. 1926);*Est. of Carew*, 311 A. 2d 185 (N.J. 1973); Treas. Reg. §20.2031-2(f). This assumes, however, that the value of the stock is not fixed by a business purchase agreement that excludes the value of the proceeds from the purchase price.

The full value of the proceeds (and not just the cash surrender value before death) will be treated as a corporate asset in valuing the insured’s stock. *Kennedy v. Comm.*, 4 BTA 330 (1926); *In re Patton’s Will*, above.

Business Life Insurance

However, where the insured stockholder is the manager or one of the principal managers of the business, his death can mean a significant loss to the company; this factor should be taken into account in placing an estate tax value on his stock. Thus, if his executor can show that in all probability the business will suffer financial loss because of the insured’s death, the IRS or the courts may permit this loss to be reflected in the value of the stock. Rev. Rul. 59-60, §4.02(b), 1959-1 CB 237; *Newell v. Comm.*, 66 F. 2d 103 (7th Cir. 1933).

Where the corporation owns key person insurance, the loss of the insured’s services may offset the increase in value of the stock caused by the insurance proceeds. *Newell v. Comm.*, above; *Est. of Huntsman*, 66 TC 861 (1976), acq. 1977-1 CB 1.

The Service has recognized the possible reduction in value of stock due to loss of the manager’s services. In a general guide to the valuation of close corporation stock (Rev. Rul. 59-60, above), the Service says:

“The loss of the manager of a so-called ‘one-man’ business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors that offset, in whole or in part, the loss of the manager’s services. For instance, the nature of the business and its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management may be employed on the basis of the consideration paid for the former manager’s services.” (See also Rev. Rul. 83-120, 1983-2 CB 170).However, the executor must be prepared to submit proof of potential loss to the corporation. In one case, for example, the court held that the insured executive’s stock was increased in value by reason of the key person proceeds, but that his estate had not submitted adequate proof of loss to the company sufficient to support a reduction in the stock’s value due to loss of his services. *Est. of Scherer*, 1940 P-H BTA Memorandum Decisions ¶40,530.

No decrease in value for loss of insured’s services will be allowed if the stock is stock of a personal holding company whose assets consist almost entirely of stocks and bonds. The corporation must be an operating business requiring management, with going value and good will. *In re Patton’s Will*, above.

Business Life Insurance

In valuing, for estate tax purposes, the shares of stock of a closely held corporation, the regulations say you take into consideration the company’s net worth, prospective earning power and dividend-paying capacity, and other relevant factors. Many of these “other relevant factors” are specified in paragraph (f) of Treas. Reg. §20.2031-2. In 1974, the following sentence was added to paragraph (f): “In addition to the relevant factors described above, a consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.”

The occasion for this addition was the simultaneous amendment of the regulations under IRC Section 2042 to provide that to the extent proceeds of insurance owned by a corporation on the life of a controlling stockholder 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 such proceeds will be attributed to the insured. (See Insurance on Controlling Stockholders, above.)

Under prior regulations, in the case of an insured who was the sole shareholder, insurance was brought into the insured’s estate *under IRC Section 2042*, because the insured was deemed to possess the incidents of ownership owned by the corporation. But the regulations were amended to provide that no longer would mere ownership of stock cause such attribution of incidents of ownership. Accordingly, the regulations *under IRC Section 2031* were amended to make clear that insurance proceeds received by the corporation would not be simply added to the insured’s gross estate, as before (in the case of a sole shareholder), but would be considered, along with other corporate (nonoperating) assets, in valuing the stock included in the insured’s estate.

Illustrative of the point just made is a case decided by the Tax Court in 1976, the first to interpret the meaning of the amendment. Two closely held corporations had received death proceeds from insurance they owned on the life of their president and sole shareholder. The court flatly rejected the Commissioner’s argument that the value of the stock was to be ascertained by first finding the value of the stock without the life insurance proceeds and then adding the proceeds to such value. The IRS acquiesced in the decision the following year. *Est. of Huntsman*, 66 TC 861 (1976), acq. 1977-1 CB 1.

Business Life Insurance

In a later case, the Tax Court added that *Huntsman* does not state that life insurance proceeds will not increase the value of stock by the full value of the proceeds. *Huntsman* concludes that the life insurance proceeds will be factored into the valuation of the stock under the valuation methods being used to value the stock and will not necessarily result in an increase equal to the full value of the insurance proceeds. The court noted, however, that the valuation methods for the stock in the later case do result in an increase equal to the full value of the insurance proceeds. *Est. of Blount v. Comm.*, TC Memo 2004-116. However, on appeal the value of the life insurance was offset by the corporation’s obligation to use the proceeds to satisfy a buy-sell agreement. Although the buy-sell agreement failed to set the value of the stock for estate tax purposes, the agreement was a valid obligation under state law. *Est. of Blount v. Comm.*, 2005-2 USTC ¶60,509 (11th Cir. 2005).

Key Person Insurance Owned by a Partnership

The estate tax results of key person insurance owned by a partnership on the life of a partner should be comparable to those of key person insurance owned by a corporation. Consequently if the partnership is both owner and beneficiary the insured should not be deemed to have any incidents of ownership so as to cause inclusion of the proceeds in his gross estate.

However, the only case law on this subject consists of two Tax Court cases that arose under the law as it existed prior to the 1954 Code. In both these cases, the Tax Court held that the proceeds of the partnership-owned insurance were not includable in the insured partner’s estate under either the premium payment test or the incidents of ownership test. *Est. of Atkins v. Comm.*, 2 TC 332 (1943); *Est. of Knipp v. Comm.*, 25 TC 153 (1955), acq. in result, 1959-1 CB 4. For dictum in support of the *Knipp*case see also *Watson v. Comm.*, TC Memo 1977-268.

Effect of Proceeds on Value of Insured’s Partnership Interest

In general, the rules of valuing a partnership interest are the same as those for valuing an interest in a close corporation. (See "Effect of Proceeds on Value of Insured’s Stock"). Thus (in the absence of a business purchase agreement which excludes the value of the proceeds), the proceeds are includable as a partnership asset in valuing the insured partner’s business interest. Accordingly, the value of his partnership interest will be increased by a share of the proceeds proportionate to his interest in the partnership.

Business Life Insurance

Effect of Insured’s having Incidents of Ownership in Key Person Policy

Ordinarily, if the insured has any incidents of ownership in the policy, such as the right to change the beneficiary, the entire proceeds are includable in his gross estate, and not just a share proportionate to his business interest. In other words, the proceeds are taxable in his estate as insurance, under IRC Section 2042(2), rather than as an increase in the value of his business interest, assuming the insured is a partner or stockholder.

However, there is authority for a different result in exceptional cases. At "Determining who Possesses the Incidents of Ownership," there is an examination of cases dealing with the phenomenon of “policy facts versus intent facts.” See, in particular, the paragraph concerning *Watson v. Comm.* In Let. Rul. 8610068, a corporation (P) indicated through its president an interest in investing $2.5 million in another corporation (M) on the condition that M purchase and maintain $3 million of key person life insurance on the life of M’s president. Pursuant to a resolution passed by M’s board of directors that M purchase and maintain $3 million of insurance on the president’s life (confirmed by minutes of the meeting), the insurance was acquired in two stages. First, M purchased three whole life policies totaling $1.5 million from insurer X. These policies showed M as owner and beneficiary. Nine months later, M purchased from insurer Z $1.5 million of term insurance on the life of M’s president. This policy showed M as the beneficiary and the insured (decedent) as owner. All premiums were paid by M. The decedent did not exercise any incidents of ownership. All the evidence indicated that both M and the decedent considered all the policies to be strictly key person insurance owned by and payable to M. The IRS followed the Tax Court’s reasoning in Est. of Fuchs, 47 TC 199 (1966), acq. 1967-1 CB 2 (cited at "Where Proceeds are Payable to Insured’s Estate or Insured Possesses Incidents of Ownership", above), and held that in this case, as in *Fuchs*, the intent facts should overrule the policy facts, and that the death proceeds of the term policy should not be includable in the decedent’s estate under IRC Section 2042(2).

#  B—Business Purchase Agreements

Cross-Purchase Arrangements: Insurance Owned by Individual Partners or Stockholders

Under the standard cross-purchase arrangement, each partner or stockholder purchases insurance on the life of each other partner or stockholder. The purchaser retains ownership of the insurance and makes the proceeds payable to himself. Upon insured’s death he uses the proceeds to carry out the terms of the business purchase agreement.

Business Life Insurance

The Internal Revenue Service has ruled that the death proceeds under this type of arrangement are not includable in the insured’s gross estate. There is no basis for taxing the proceeds in insured’s estate since the insured does not have any incidents of ownership in the policy and the proceeds are not payable to his estate. It is immaterial that the parties have made reciprocal purchases of policies on each other’s lives; the “reciprocal trust doctrine” does not apply here. Rev. Rul. 56-397, 1956-2 CB 599.

In *Est. of Infante v. Comm.*, TC Memo 1970-206, appeal dismissed, 7th Cir. 1971, however, the IRS sought to find an incident of ownership in the insured (in the insurance on his own life) based on the following provision in the buy-sell agreement between two partners: “so long as this agreement remains in force and prior to the death of either of the partners, neither partner will borrow against or surrender the policy or policies which he owns for the purpose of this agreement, or change the beneficiary or make a settlement thereof without the consent of the other partner hereto.” The IRS claimed that the veto power this provision gave the insured over this partner’s exercise of ownership rights in the insurance on his life was an incident of ownership within the meaning of IRC Section 2042(2). The Tax Court rejected the IRS argument and held for the taxpayer. (The Service admitted that if the life insurance proceeds are includable in the insured’s estate, the insured’s partnership interest should not be. In this case the amount of the insurance proceeds exceeded the value of the insured’s partnership interest, and so the IRS sought the bigger purse. Where the amount of proceeds does not materially exceed the value of the deceased’s partnership interest, the issue raised by this case is of no consequence.) It has been reported that the IRS, citing an internal ruling from the Commissioner dated January 7, 1971, has declined to follow the *Infante* decision. 55 *Taxes* (CCH) 146 (Feb. 1977).

A technical advice memorandum determined that an insured would be treated as holding incidents of ownership in a policy held in a trusteed buy-sell arrangement where the trust could only act as directed by the shareholders through the buy-sell agreement and the insured could thus withhold her consent to the exercise of policy rights. TAM 9349002. However, a letter ruling provided that no estate inclusion was required for life insurance held in a trust to fund a corporate buy-sell agreement. Let. Rul. 9511009. Another letter ruling determined that life insurance proceeds would not be includable in insureds’ estates under IRC Section 2042(2) where the life insurance policies would be transferred to an irrevocable trust to fund a buy-sell agreement and the trustee would be a third party unrelated to the insureds, would not be a shareholder of the corporation which is the subject of the buy-sell agreement, and would hold all ownership rights in the policies. Let. Rul. 9622036.

Business Life Insurance

A shareholder was not treated as holding incidents of ownership in a life insurance policy where the shareholder could purchase a corporate-owned policy upon disability, or upon a cross-purchase of his stock if he dissented to sale of the corporation to a third party or a public offering. Let. Rul. 9233006. Similarly, a sole shareholder would not be treated as holding incidents of ownership in a life insurance policy on his own life where a collateral consequence of a termination of an employee’s employment would be a termination of the employee’s option agreement to purchase the shareholder’s stock with a corresponding change in beneficiary of the insurance proceeds held in an irrevocable life insurance trust created by the employee. TAM 9421037.

Of course, the value of insured’s *business interest* is includable in his gross estate (see "Fixing Estate Tax Value of Business Interest by Purchase Agreement," below).

Also includable in the insured’s gross estate is the value of the unmatured policies he owned on the lives of the other partners or stockholders.

Entity Arrangement: Insurance Owned by Partnership or Corporation

Under the “entity” type of insurance-funded business purchase agreement, the insurance is owned by and payable to the partnership or corporation (or to a trustee who must use the proceeds to purchase the insured’s business interest for the business entity).

Where the business entity is a corporation, the estate tax consequences concerning the insurance proceeds are the same as where a corporation owns key employee insurance. Where the insured is a controlling stockholder, the IRS’s position is that the life insurance proceeds should be reflected in the valuation of the decedent’s stock includable in decedent’s gross estate under IRC Section 2033, and not separately included in the decedent’s gross estate under IRC Section 2042. Rev. Rul. 82-85, 1982-1 CB 137. See also *Est. of Huntsman*, 66 TC 861 (1976), acq. 1977-1 CB 1. This position is consistent with the clear meaning of the regulations construing IRC Section 2042, which say, in part: “In the case of economic benefits of a life insurance policy on the decedent’s life that are reserved to a corporation of which the decedent is the sole or controlling stockholder, the corporation’s incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corporation for purposes of the preceding sentence.” Treas. Reg.

Business Life Insurance

§20.2042-1(c)(6). Moreover, it is obvious that the life insurance proceeds benefit both the buyer and the seller, and the regulations under IRC Section 2031 say that in valuing the corporation’s stock, consideration must be given to the proceeds of life insurance policies payable to or for the benefit of the corporation. Treas. Reg. §20.2031-2(f). If life insurance proceeds are considered in valuing the decedent’s stock under IRC Section 2031, the same proceeds are not added directly to the decedent’s estate under IRC Section 2042 (see above—Key Person Life Insurance, subsection "Effect of Proceeds on Value of Insured’s Stock").

The IRS has held that where, under an entity type agreement, a stockholder had the right to purchase the policies the corporation owned on his life if he ceased being a shareholder, the contingent purchase option was not an incident of ownership in the insurance. Let. Rul. 8049002. (See also above—Key Person Life Insurance). More recently, a memorandum stated that an insured who held the right to purchase a policy upon termination of a buy-sell agreement did not possess incidents of ownership so long as the contingency had not occurred, but would possess incidents once the agreement was terminated. TAM 9127007.

As in the case of key man insurance, where the business entity is a partnership, the estate tax consequences are a bit less predictable than where the business entity is a corporation. The underlying reason is that in the eyes of the law, a partnership is not a separate entity as completely or as permanently or in the same sense as is a corporation. A partnership is recognized only for some purposes as an entity apart from the partners who comprise it. Consequently, it is conceptually easier to argue that incidents of ownership nominally owned by the partnership are actually owned by the individual partners. (For commentary, see Stephens, Maxfield, Lind and Calfee, *Federal Estate and Gift Taxation* (Boston: Warren, Gorham & Lamont), 7th ed., ¶4.14[5][b].)

The value of the business interest is, of course, includable in insured’s gross estate. *Wilson v. Crooks*, 52 F.2d 692 (W.D. Mo. 1931); *Est. of Ealy v. Comm.*, TC Memo 5-9-51; *Est. of Riecker v. Comm.*, TC Memo 12-11-44; *Est. of Atkins v. Comm.*, 2 TC 332 (1943); *Est. of Knipp v. Comm.*, 25 TC 153 (1955), acq. in result, 1959-1 CB 4.

In valuing the insured’s business interest, a part of the proceeds proportionate to the insured’s interest in the business will be included unless: (1) the proceeds are excluded from the purchase price under the terms of the agreement, and (2) the agreement is effective in fixing the value of the business interest for estate tax purposes. *Newell v. Comm.*, 66 F.2d 102 (7th Cir. 1933); *Kennedy v. Comm.*, 4 BTA 330 (1926), acq. VI-1 CB 3; see also *Est. of Salt v. Comm.*, 17 TC 92 (1952), acq. 1952-1 CB 4; *Est. of Littick*

Business Life Insurance

*v. Comm.*, 31 TC 181 (1958), acq. in result 1984-2 CB 1; AOD/CC-1985-008, 12/24/84; *Rubel v. Rubel*, 75 So. 2d 59 (Miss. 1954).

Where Proceeds are Payable to Insured’s Estate or Insured Possesses Incidents of Ownership

If the proceeds of the funding insurance are payable to insured’s estate or if the insured has incidents of ownership in the policy, the value of the proceeds is includable in his gross estate. But if, under the agreement, the proceeds must be applied to the purchase price of insured’s business interest, then the value of the business interest is 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. *Est. of Mitchell v. Comm.*, 37 BTA 1 (1938), acq. 1938-1 CB 20; *Est. of Tomkins v. Comm.*, 13 TC 1054 (1949), acq. 1950-1 CB 5; *Est. of Ealy v. Comm.*, TC Memo 1951; *Dobrzensky v. Comm.*, 34 BTA 305 (1936), nonacq. XV-2 CB 39;*Boston Safe Deposit & Trust Co. (Est. of Schovell) v. Comm.*, 30 BTA 679 (1934), pet. for rev. dism’d. (1st Cir. 1934); Press. Memo., 11-24-47.

Ordinarily the terms of the policy will prevail in determining whether the insured has any incidents of ownership. However, there is some case authority to the effect that the terms of the policy can be controlled by the buy-sell agreement. In *First Nat’l Bank of Birmingham*, for example, the Court held that insured did not have the right to change the beneficiary even though he was granted that right under the terms of the policy. The Court concluded that, under Alabama law, the policy right was nullified by the buy-sell agreement that required the proceeds to be applied to the purchase of insured’s business interest. *First Nat’l Bank of Birmingham, (Estate of Smith) v. U.S.*, 358 F.2d 625 (5th Cir. 1966); see also*Est. of Fuchs v. Comm.*, 47 TC 199 (1966), acq. 1967-1 CB 2.

Fixing Estate Tax Value of Business Interest by Purchase Agreement

It is generally agreed that it is possible by means of a business purchase agreement to fix the value of a business interest for estate tax purposes. However, IRC Section 2703 provides that buy-sells and other agreements between family members exercisable at less than fair market value are to be disregarded in valuing property subject to such an agreement unless the following three tests are met: (1) the bona fide business arrangement test, (2) the full and adequate consideration test, and (3) the comparable test. IRC Section 2703 applies to agreements, options, rights or restrictions entered into

Business Life Insurance

or granted after October 8, 1990, and agreements, options, rights or restrictions substantially modified after October 8, 1990.

 Whether or not the buy-sell agreement is subject to IRC Section 2703, the additional following rules have been established over the years.The Internal Revenue Service officially takes the position that the facts of each case must be examined to determine whether the price agreed upon by the parties will be accepted for estate tax purposes. Treas. Reg. §20.2031-2(h); Treas. Reg.  §20.2031-3; Rev. Rul. 59-60, 1959-1 CB 237.

The regulations do not set forth the conditions under which an agreement will control estate tax value, but they do contain negative provisos as to when the agreement will not control.

Thus, the regulations state that little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the business interest at any price he chooses during his lifetime. Moreover, even if the decedent is not free to dispose of the business interest at other than the option or contract price, such price will be disregarded unless the agreement is a bona fide business arrangement and not a device to pass the business interest to decedent’s heirs for less than it is worth. Treas. Reg. §20.2031-2(h).

Although the regulations state that each case will be decided on its facts, the courts have held, in numerous cases, that the price in the agreement will control if the following conditions are met:

* The estate must be obligated to sell at death (under either a mandatory purchase agreement or an option held by the designated purchaser).
* The agreement must prohibit the owner from disposing of his interest during his lifetime at a price higher than the contract or option price.
* The price must be fixed by the terms of the agreement or the agreement must contain a formula or method for determining the price. Let. Rul. 8710004.
* The agreement must be an arm’s length business transaction and not a gift or a testamentary device. Thus, the purchase price must be fair and adequate at the time the agreement is made, particularly if the parties are closely related. Est. of True v.

Business Life Insurance

Comm., 2004-2 USTC ¶60,495 (10th Cir. 2004); Slocum v. U.S., 256 F. Supp. 753 (S.D.N.Y. 1966); St. Louis County Bank, 674 F. 2d 1207 (8th Cir. 1982); Let. Rul. 8710004. An agreement may be found to be a scheme for avoiding estate taxes even where it serves a bona-fide business purpose. St. Louis County Bank v. U.S., 49 AFTR 2d ¶148,515 (8th Cir. 1982).

In all of the following cases, the price set in the agreement was held to control the estate tax value of the business interest: *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955); *May v. McGowan*, 194 F.2d 396 (2nd Cir. 1952); *Comm. v. Child’s Est.*, 147 F.2d 368 (2nd Cir. 1952); *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); *Mathews v. U.S.*, 226 F.Supp. 1003 (E.D. N.Y. 1964); *Citizens Fidelity & Trust Co.*, 209 F.Supp. 254 (W.D. Ky. 1962); *Third Nat’l Bank v. U.S.*, 64 F.Supp. 198 ((M.D. Tenn. 1946); *Davis v. U.S.*, 5 AFTR 2d 1902 (D. Utah 1960); *Mandel v. Sturr*, 266 F.2d 321; *Fiorito*, 33 TC 440 (1959), acq. 1960-1 CB 4;*Est. of Littick*, 31 TC 181 (1959), acq. in result 1984-2 CB 1; AOD/CC-1985-008, 12/24/84; *Est. of Weil*, 22 TC 1267 (1954), acq. 1955-2 CB 10; *Est. of Salt*, 17 TC 92 (1951), acq. 1952-1 CB 4; *Maddock Est.*, 16 TC 324, acq. 1951-2 CB 3; *Est. of Seltzer v. Comm.*, TC Memo 1985-519. See also TAM 8541005.

The mere fact that the agreement has the purpose and effect of maintaining family ownership and control of a business from one generation to another is not fatal to the ability of the agreement price to control the estate tax value; if the buy-sell arrangement is grounded on a bona-fide business purpose, and if the other conditions (above) are met, the agreement price is likely to hold. *Est. of Bischoff*, 69 TC 32 (1977); *Est. of Seltzer v. Comm.*, TC Memo 1985-519. However, IRC Section 2703, see above, provides that the purchase agreement may not be a device to transfer the property to members of the decedent’s family for less than full or adequate consideration in money or money’s worth.

The fact that the value of goodwill is excluded from the purchase price does not invalidate the agreement. *Est. of Fiorito v. Comm.*, 33 TC 440 (1959); *Est. of Seltzer v. Comm.*, TC Memo 1985-519.

If a business purchase agreement calls for shares to be purchased from the estate with installment purchase notes bearing a rate of interest lower than the market rate at date of death, the 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 rate prevailing at date of death. Let. Rul. 8245007.

Business Life Insurance

The courts as well as the regulations hold that no effect will be given to an option or contract under which the decedent is free to dispose of the business interest at any price he chooses during life. *Est. of Gannon*, 21 TC 1073 (1954); *Est. of Trammell*, 18 TC 662 (1952); *Est. of Mathews*, 3 TC 525 (1944);*Hoffman*, 2 TC 1160 (1943); *Est. of Tompkins*, 13 TC 1054 (1949); *Est. of Caplan*, TC Memo 1974-39; TAM 8634004.

On the other hand, an agreement that restricts sale during life but not at death will fail to fix estate tax value. *Land v. U.S.*, 303 F.2d 170 (5th Cir. 1962), cert. denied 371 U.S. 862.A “first offer” agreement, under which the designated purchasers have no enforceable right and can buy only if the executor wishes to sell, does not fix the value of the interest for estate tax purposes.*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. XI-1 CB 2; *Michigan Trust Co. v. Comm.*, 27 BTA 556 (1933), acq. XII-1 CB 8.

The Littick Case and the IRS

Something need be said about the unusual action taken by the IRS with respect to the Tax Court decision in *Littick*, cited above among the cases upholding the agreement price for estate tax purposes. The IRS acquiesced in that decision in 1959, the year the case was decided, then, late in 1984, withdrew its acquiescence and substituted its acquiescence in the result only. Why?

In *Littick*, three brothers were shareholders in a closely held corporation. They entered into a cross purchase buy-sell agreement. One brother died a year later, and, pursuant to the agreement, the two surviving stockholders purchased his stock at the agreement price, $200,000. The decedent’s executor returned the $200,000 amount as the value of the decedent’s stock on the federal estate tax return. The IRS levied a deficiency, contending that the amount returned should have been $257,910.57, the IRS’s determination of the fair market value.

In Tax Court the IRS and the estate stipulated that the fair market value was $257,910.57. The IRS argued that because the decedent was suffering from cancer at the time the buy-sell agreement was entered into, the agreement was not a bona fide business arrangement but rather an estate planning device intended primarily to pass the decedent’s shares to the natural objects of his bounty for less than adequate consideration. (In other words, the IRS was arguing that the agreement did not meet the fourth condition described above.)

The court held that the contract price controlled for estate tax purposes, that the agreement was negotiated at arm’s length for the purpose of keeping control of the corporation in its present management. The court discounted the fact that the terminally

Business Life Insurance

ill decedent was likely to predecease his brothers, stating that this was not necessarily a foregone conclusion. The court further stated that the execution of the agreement was not in itself a present transfer of the shares (as the IRS had argued), but was merely an agreement to sell the shares in the future at a specified price.The reasoning of the IRS with respect to the court’s decision is contained in the last two paragraphs of AOD/CC-1985-008, which recommended the action taken by the Service in 1984:

“Substantial disparity in the life expectancies of the contracting parties means that the promise of the party likely to predecease was worth more than the promises of the other parties. Therefore, the exclusion of the cross-purchase agreement gave rise to an immediate transfer of a contract right for less than adequate consideration. Since this was an intra-family agreement, the transaction should be closely scrutinized to determine whether it was executed as a gift or in the ordinary course of business under Reg. §25.2512-8. In our view, the court improperly ignored the great weight of the evidence when it found that the instant agreement was negotiated at arm’s length with no tax avoidance motive. However, inasmuch as the court’s determination was a factual one with some support in the record, the decision was not clearly erroneous.

“Nevertheless, we reject any implication from this decision that a cross-purchase agreement is supported by adequate consideration without regard to the life expectancies of the parties.”

If this reasoning were taken to its logical conclusion, any noninsured cross-purchase agreement between related parties with differing life expectancies (by reason of age, gender, or health differences) could give rise to gift tax liability. We can only speculate on how far the Service will carry its thinking along this line. In any event, at least in cases where all the parties are insurable, an insured cross-purchase agreement should solve any similar problem, because each party pays an insurance premium that precisely reflects the mortality risk for each participant.

# C—Insurance as Employee Compensation

Where insurance is purchased by an employer for the benefit of the employee, normally the employee will own incidents of ownership in the insurance, causing the proceeds to be includable in his estate for estate tax purposes. To avoid the estate tax many employees, especially at the executive level, are advised to transfer their incidents of ownership to their spouses or their children or to irrevocable trusts. The IRS has ruled that where a partnership owns individual (i.e., not group) insurance on the life of a partner payable to the partner’s personal beneficiary, the partner possesses, in his capacity as a partner, an incident of ownership in such insurance for purposes of IRC

Business Life Insurance

Section 2042(2). Accordingly, if the insured dies possessing such incident of ownership and the proceeds are payable to his named beneficiary, the proceeds will be includable in his estate under IRC Section 2042. The result will follow whether the partner is a majority or a minority partner. Rev. Rul. 83-147, 1983-2 CB 158.

In TAM 8246011, A, the decedent, was one of three equal stockholders in corporations X and Y. A and the other two nonrelated shareholders, B and C, agreed individually and as shareholders to have X and Y obtain and own insurance policies on their lives for the benefit of their respective spouses. When the policies on A’s life were obtained by X and Y, A signed the application form for each policy as the proposed insured and also as president of X and Y. X and Y at all times owned the incidents of ownership in and made the premium payments on the policy each owned. A reported as taxable income the amount of premium payments made by X and Y on his policies. One policy was issued in 1979 and the other in 1980. Similar insurance policies were obtained by X and Y on the lives of the other stockholders. A died within three years of the purchase of the policies on his life. (Presumably, A’s death occurred in 1981 rather than in 1982 (the memorandum deleted the date of death) because the reference to IRC Section 2035 did not mention the changes made by ERTA.) Citing *Bel* and the *First Nat’l Bank of Oregon* cases as precedent, the IRS ruled that the proceeds of the policies on A’s life were includable in his gross estate under IRC Section 2035, reasoning that the corporations had acted as the shareholders’ alter ego in procuring the insurance for their personal benefit, that A had indirectly paid the premiums for the policies on his life, and that there had been a transfer of the policies for purposes of IRC Section 2035 to X and Y.