Double Taxation: A Take On All Things Taxes

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Avoiding The Trap on Employer-Owned Life Insurance Contracts

May 9, 2012 by WithumSmith Brown, CPAs

On corporate tax returns, it's second nature to disallow any deductions for "officer's life insurance premiums" expensed on the corporation's books. But why do we do it?

Under I.R.C. § 101, life insurance proceeds paid upon the death of an insured to the beneficiary are generally excludable from the beneficiary's income. Thus, when a corporation takes out a life insurance policy on one if its key employees — and the corporation is both the owner and beneficiary of the policy – the proceeds paid to the corporation upon the death of the employee are generally tax-exempt.

Because I.R.C. § 101 serves to exclude life insurance proceeds from income, I.R.C. § 264 prevents a second tax benefit by disallowing a deduction for any premiums paid on a policy on which the payor is the beneficiary. That way, the taxpayer doesn't get a deduction for premiums AND tax-exempt proceeds when the policy is paid out.

But did you know that for policies issued after August 17, 2006, the proceeds from corporate owned life insurance policies *may* be taxable to the corporation upon receipt? Unless certain notice and consent requirements are met, I.R.C. § 101(j) provides that life insurance premiums paid to a corporation upon the death of an employee will be excludable from income only to the extent of any premiums or other amounts paid for the policy. Proceeds in excess of such costs will be taxable to the corporation.

In order for the entire amount of life insurance proceeds to be tax-exempt to the beneficiary corporation, the employee must:

1. Be notified in writing that the applicable policyholder (employer) intends to insure the employee's life and of the maximum face amount of the policy at the time of issue,

2. Must provide written consent to being insured and that the coverage may continue after the insured terminates employment, and

3. Must be informed in writing that the applicable policyholder (employer) will be a beneficiary of any proceeds payable upon the death of the employee.

In addition, every applicable policyholder corporation owning one or more employer-owned life insurance contracts issued after August 17, 2006 must file a Form 8925 for each year such contracts are owned, showing:

1. The number of employees at the end of the year and the number of those employees insured under employer-owned life insurance contracts;

2. The total amount of insurance in force under such contracts at the end of the year;

3. The name, address, TIN, and type of business of the applicable policyholder; and

4. That the applicable policyholder has a valid consent for each insured employee or the number of insured employees for which no consent has been obtained.

A few weeks ago, in PLR 201217017 (http://www.irs.gov/pub/irs-wd/1217017.pdf), the IRS ruled that a corporation met the notice and consent requirements even where the corporation failed to acquire separate documentation prior to purchasing life insurance contracts on each shareholder/employee that explicitly satisfied the items detailed in I.R.C. § 101(j).

Instead, the corporation required each shareholder/employee to fill out insurance applications that indicated that the corporation was to be the owner and beneficiary of the policy, as well as the amount of coverage being obtained, while also requiring the shareholder/employees to sign an agreement dictating that if the shareholder terminates his ownership interest, the shareholder has the right to purchase the policy from the corporation.

The IRS concluded that between the application and the agreement signed by the participating shareholder/employees, the notice and consent requirements had been met and I.R.C. § 101(j) was satisfied. Thus, proceeds received by the corporation upon the death of any of the insured's will be tax-free under I.R.C. § 101.

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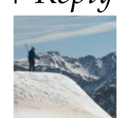

[...] It's easy to forget that if you don't cross your T's and dot your I's, officer's life insurance proceeds can be taxable to the employer. [...]

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