Transfer of Policy to or from a Business

Overview

Certain tax issues arise when transferring a life insurance policy to or from a business. For the most part, life insurance is treated like other appreciated property. Key factors include: the fair market value of the property, the owner's cost basis, and whether the transfer triggers tax recognition. If taxable, what type of tax is involved: ordinary income or capital gain.

Description and Operations

Business Entities: C corporations, S corporations, partnerships, and sole proprietorships each have certain business advantages and disadvantages and are taxed differently. A limited liability company (LLC) can elect whether it will be taxed as a C corporation, S corporation, partnership, or, if it has only one member, a sole proprietorship. A sole proprietorship is disregarded as an entity for tax purposes, and all property of the business is owned by the sole proprietor.

Fair Market Value (FMV) of Policy: When transferring a policy to a business, whether as a capital contribution or by purchase, valuation is always an issue. Likewise, when a policy is distributed from the business, whether as compensation, dividend, or sale, attributing the proper value is a key component of the transaction.

Rev. Proc. 2005-25 provides that the FMV of a policy distributed from a business is the greater of (1) the policy's modified interpolated terminal reserve (ITR) value or (2) the adjusted "PERC" amount, which is premiums plus earnings minus reasonable charges. The modified ITR includes the ITR provided by the insurance company, plus unearned premiums and reasonable dividends. The policy's reserve value is often used as the ITR for a universal life policy, since a UL policy technically does not have an ITR. Rev. Proc. 2005-25 also requires that the fair market value of the contract take into account all rights under the contract, including related endorsements, promises, or agreements. Cash surrender values are generally not an adequate representation of a policy's FMV, especially for a UL policy that has a guaranteed death benefit but little cash value. There is no specific guidance for valuing a policy transferred to a business. Any reasonable method that reflects all policy benefits and values, including the FMV methods of Rev. Proc. 2005-25, should be sufficient to determine the policy's FMV.

Tax Implications

Income Tax Considerations

Transfer to a Business: A life insurance policy can be transferred to a business as a capital contribution in exchange for stock or through a sale and purchase. Money or property going from an owner into a business is a capital contribution that gives the business owner a tax basis (investment) in the business. If the transfer of the policy is tax-free, such as to a partnership or by controlling (80% or more) shareholder(s) to a corporation, the business will have the same basis as the owner making the transfer.[1] If gain is recognized on the transfer, such as a transfer made to an investment partnership or to a corporation by a non controlling shareholder, the business' basis in the property will be the transferor's basis increased by the amount recognized on the transfer.

Transfer from a Business: Depending upon the circumstances, money or property distributed from the business to a business owner is treated as a return of capital, dividend, or compensation. When life insurance is contributed to or distributed from a business, it will be taxed similar to other property. The income tax considerations of transferring appreciated property, including a life insurance policy, to or from a business are summarized in the table on the following page.

Taxation of Income and Transfers to or from Various Business Entities

	C Corporation	S Corporation	Partnership/LLC*
Income Taxation in General	• Corporation pays income tax if it has taxable income. • Compensation paid is deductible, if reasonable. • May be subject to Corporate Alternative Minimum Tax (CAMT) due to increase in insurance cash value and receipt of death proceeds.	• S Corporations do not pay income tax. All earnings and losses are passed through to the shareholders. • Flow through amounts are reported on shareholder Form K-1; income taxable to Shareholder but not subject to FICA. • Compensation paid to an employee is subject to FICA.	• Partnerships do not pay income tax. All earnings and losses are passed through to the partners. • Partners pay self employment tax on their share of partnership income.
Transfers of Appreciated Property to Business	Gain recognized unless transferor(s) own 80% or more of stock after transfer. Loan on the property in excess of basis may trigger gain.	Gain recognized unless transferor(s) own 80% or more of stock after transfer. Loan on the property in excess of basis may trigger gain.	Generally, no recognition of gain unless partnership is investment partnership or property has a loan in excess of basis.
Cash Distributions	• Dividends are taxable at 20% (currently) to shareholder to the extent of earnings and profits (E&P). • Dividends are not deductible.	• Distributions from AAA (if former C corp) - not taxable but reduces shareholder's basis. • Distributions from E&P (if former C corp) does not reduce basis but is taxable to shareholder. • Capital Gain – distributions in excess of basis are capital gain.	• Return of Basis – not tax to partner, but his/her basis is reduced by distribution. • Capital Gain – distributions that exceed partner's basis are subject to capital gain.

* A limited liability company (LLC) may elect to be taxed as a corporation (C or S), partnership, or, if it only has one member, a sole proprietorship. Usually, an LLC elects to be taxed as a partnership.

[1] IRC §§351(a) and 368(c).

	C Corporation	S Corporation	Partnership/LLC*
Distributions of Appreciated Property** – Business Taxation	• Gain (FMV – Basis) is taxable to corporation.*** • Property distributed as compensation is deductible, if reasonable. Gain is offset by deduction. • Property distributed as dividend, is nondeductible to corporation.	• Gain (FMV – Basis) is taxable to shareholders.*** • Property distributed as compensation is deductible, if reasonable. Gain is offset by deduction. • Built-in gains (recognized from sale or distribution of prior C corp property) taxable to S corp at highest C corp rate.	Gain is generally not recognized on distribution; it is recognized at the time of sale by distributee partner.
Distributions of Appreciated Property – Owner / Employee Taxation	• Taxable amount is property's FMV. • If dividend, taxable at 20% (currently). • If compensation, taxed as ordinary income at the shareholder's marginal rate.	• Compensation – taxable at shareholder's marginal rate. • Distributions from AAA (if former C corp) – not taxable but reduces shareholder's basis. • Distributions from E&P (if former C corp) does not reduce basis but is taxable to shareholder. • Capital Gain – distributions in excess of basis are capital gain.	• Gain generally not recognized on distribution; it is recognized at the time of sale by distributee partner. • AMT may be recognized by partner. • Partner's basis is reduced by distribution.

** Gain on appreciated property is its Fair Market Value (FMV) in excess of tax basis (net cost).
*** Gain on appreciated property is usually capital gain; but, a life insurance policy with appreciation will yield ordinary income, plus, if the policy is sold, a capital gain to the extent the sales price exceeds the policy's surrender value.

Insights and Caveats

- Generally, a life insurance policy that is transferred to a business will not be subject to the Notice and Consent requirements of IRC §101(j) and the reporting requirements of IRC §6039I. These requirements apply to policies purchased by and issued to the business on the life of an employee.
- Anytime a life insurance policy is transferred to or from a business or among the owners, counsel should make sure that the transfer-for-value rule does not apply.

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