

Life Insurance Planning and the Closely Held Business Ownership and Beneficiary Designations

Introduction

Closely held businesses often use life insurance for important business purposes, such as to fund buy-sell arrangements or provide key man coverage. The favorable income tax attributes of life insurance (e.g., inside buildup of cash value is free of income tax, as is the death benefit) often weigh heavily in the decision to utilize life insurance. However, improper beneficiary and ownership designations can have adverse, and sometimes disastrous, income or transfer tax consequences to clients. Similarly, the structure of a closely held business that owns life insurance can also produce undesirable and unanticipated results.

Income Taxation of Life Insurance Death Benefit Proceeds

Internal Revenue Code (IRC) § 61 provides that “gross income includes all income from whatever source derived ...” One exception to this general rule is found in IRC § 101(a), which provides that gross income does not include amounts received under a life insurance contract if those amounts are paid by reason of the insured’s death. With closely held businesses, the client is often an employee and/or equity holder. In certain situations, the life insurance death benefit proceeds will be subject to income taxation. Depending on the relationship of the parties to the life insurance contract, the life insurance death benefit proceeds will be treated as compensation or dividends. In either case, the loss of the favorable income tax treatment of life insurance death benefit proceeds is costly. These issues typically arise in the following situations:

Situation 1: A closely held business is the owner and premium payor on a life insurance policy insuring a non-shareholder/employee or shareholder/employee’s life. In those cases, the life insurance death benefit proceeds will be treated as though the closely held business had distributed its earnings and profits to the shareholder/employee. As such, the distribution would be subject to income taxation as a nondeductible dividend. If the death benefit proceeds are paid to a non-shareholder employee, the payment will be as though the closely held business had paid deductible compensation to the non-shareholder/employee. As such, the payment would be subject to income taxation.¹

Situation 2: Where another party is the owner of the contract, the premium payments will be treated as compensation or a dividend unless the insured recognizes the premium payments as income as would be the case with a 162 Bonus Plan. In the case of a split dollar arrangement, the insured would report the annual economic benefit as income.

Situation 3: Where the closely held business is the owner and beneficiary of a life insurance contract, the death benefit proceeds will be subject to income taxation as compensation if the closely held business subsequently distributes the death benefit proceeds to an employee for any reason, as would be the case in a salary continuation plan.

Estate Taxation of Life Insurance Death Benefit Proceeds

Life insurance death benefit proceeds are included in a decedent's estate if the decedent held incidents of ownership of the policy.² Incidents of ownership are not limited to ownership of the policy in its technical sense and can include the right of the insured to change the beneficiaries of the policy, assign the policy, pledge the policy as security or obtain a loan against the policy.

Incidents of Ownership in the Context of a Corporation

Typically, the analysis of the potential application of IRC § 2042 in the context of the closely held corporation depends on whether the death benefit is paid to the corporation and, if not, whether the insured is a controlling shareholder.

Death Benefit Payable to Corporation

With respect to corporate-owned policies, if the proceeds are payable to the corporation the incidents of ownership of the policy will not be attributed to the insured-shareholder and the full death benefits payable on the policy will not be included in the insured-shareholder's gross estate.³

Death Benefit Paid Not Payable to Corporation

To the extent that the proceeds of the corporate-owned policy are not payable to the corporation, the corporation's incidents of ownership will be attributed to the insured-shareholder if the insured-shareholder is the sole or controlling shareholder of the corporation.⁴

For purposes of Reg. § 20.2042-1(c)(6), "controlling" means ownership of more than 50 percent of the voting power of the corporation's outstanding stock.⁵ An insured is considered to be the owner of the stock to which legal title was held by (1) him or his agent/nominee, (2) with another person jointly to the extent the insured provided the consideration for the stock, (3) a trustee of a voting trust to the extent of the insured's beneficial interest in the trust and (4) any other trust with respect to which the insured is treated as the owner of the trust's assets under the grantor trust rules.⁶

With regard to stock owned by trusts that qualify as qualified subchapter S trusts (QSSTs) the beneficiary is treated as the owner of the trust assets and may have incidents of ownership if the corporation owns a policy on his or her life and the insured's deemed ownership of the stock is in excess of 50 percent.⁷ See PLR 9511046. However, where stock owned by a qualified terminal interest property (QTIP) trust, which is not treated as a grantor trust for income tax purposes as to the spouse, is not attributed to the spousal beneficiary for purposes of Code § 2042.⁸

Transfer of Controlling Interest

With regard to a transfer of a controlling interest in a corporation for less than full and adequate consideration within three years of the date of death of the insured-shareholder, the incidents of ownership of the policy will be attributed to the insured and full value of the death benefit of the policy will be includible in the insured-shareholder's gross estate pursuant to IRC § 2035(a).⁹

Incidents of Ownership in the Context of a Partnership/LLC

The analysis of the potential application of IRC § 2042 in the context of a partnership or limited liability company (LLC) depends heavily on whether the insured has control of the life insurance contract based on his role in the partnership or LLC (i.e., general partner or managing member).

Partnership

It has been held that a partnership's power to exercise incidents of ownership of a policy is not attributable to the limited partners such that a policy owned by a limited partnership in which the insured held a limited partnership interest is not included in the insured's gross estate.¹⁰ The rulings relied on the fact that the insured as a partner had no power to exercise any ownership rights concerning the policy so that the insured did not possess incidents of ownership of the policy and the partnership was beneficiary of the policy. In theory, the insured could serve as one of the general partners so long as the partnership agreement contains provisions restricting the authority of the insured with regard to the policy.

Limited Liability Company

In the case of a limited liability company, the structure of the LLC, including the rights of the members to deal with the assets of the LLC, must be such that the insured is not considered to retain any incidents of ownership of the policy, which is to be owned by the LLC.¹¹ It should be noted that the interest in the entity owned by the insured will be included in the insured's gross estate (which could be valued, for estate tax purposes, at an amount equal to the insured partner or member's pro rata share of the underlying entity assets, including the death benefit proceeds of the policy (and any other assets of the partnership/LLC)).

Sample Insurance Provision

As the foregoing demonstrates, the partnership or LLC agreement should be structured in such a way to ensure the insured does not retain any incidents of ownership in a policy. Following is a sample insurance provision that could be incorporated in the partnership or LLC agreement, as the case may be, to address this issue.

Sample Insurance Provision/Language: "Insurance. If the Company or any other entity with respect to which the Company has operational control owns a life insurance policy (or an interest therein) insuring the life (or joint lives [as the case may be]) of any Manager (an "Insured Manager") or possesses any incident of ownership with respect to such policy(ies), the Insured Manager has no right or power to exercise or to otherwise participate in the exercise of any of the incidents of ownership with respect to such policy(ies). Such incident of ownership shall be exercised solely by a majority of the Managers other than the Insured Manager. If no such other Manager shall then be serving, the Manager shall appoint a special Manager for the sole purpose of exercising any and all of the incidents of ownership with respect to such policy(ies)."

Conclusion

The use of life insurance by a closely held business can make great economic sense and provide the closely held business or its owners a needed infusion of cash at precisely the right time. To ensure life insurance delivers as planned (i.e., the beneficiary receives the death benefit free from income or estate tax, as the case may be), it is crucial that the ownership of the policy and the beneficiary designations align with the plan design and the anticipated income and transfer tax results.

¹Rev. Rul. 61-134, 1961-2 CB 250; *Golden v. Comm'r*, 113 F.2d 590 (3d Cir. 1940).

²IRC § 2042.

³Reg. § 20.2042-1(c)(6) and TAM 8906002.

⁴Reg. d 0.2042-1(c)(6).

⁵PLR 9428010.

⁶Reg. § 20.2042-1(c)(6).

⁷PLR 9511046.

⁸PLR 9848011.

⁹Rev. Rul. 90-21, 1990-1 C.B. 172.

¹⁰Rev. Ruling 83-177, 1983-2 CB 112; Rev. Ruling 83-148, 1983-2 CB 157; PLR 9843024 and PLR 200111038.

¹¹PLR 200747002.

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