BRIAN T. WHITLOCK, CPA, J.D., LL.M., is a Practicing Attorney and Of Counsel with Golan Christie Taglia, LLP. He is also an Adjunct Member of the faculty at the Northwestern University Pritzker School of Law.

Untaxingly Yours

A Practical Guide to Life Insurance: Part II—Income, Gift, and Estate Tax Implications (Traps for the Unwary)

By Brian T. Whitlock

This is the second of two columns. In the first column, we explored the world of life insurance, some of the common terminology, and some of the marketing strategies that underlie insurance contracts.

In this column, Part II, we will explore the income and estate tax aspects of life insurance, including some traps for the unwary in terms of how the life insurance contracts should be owned and where the death benefits should best flow.

Income Taxation of Life Insurance

Life insurance is frequently referred to as being income tax neutral. Premiums paid are not income tax deductible, if the payor is also the beneficiary of the policy[1]; and similarly, the death benefit is generally excluded from gross income.[2]

The owner of the policy may be able to access the cash that has built up in the policy during its lifetime, if the owner has basis and is able to properly structure a loan. Additionally, where the insured is chronically ill[3] or terminally ill (expected to die in 24 months or less), Congress added the ability of the insured to sell or assign a portion of the death benefit and extract cash "tax-free" from the policy in what is known as a "viatical settlement" of the policy under Code Sec. 101(g).

Businesses frequently purchase life insurance on the lives of key employees and equity owners. The purchase of life insurance policies on the lives of equity owners can aid in the purchase of a deceased owner's equity interest. If the business purchases and owns the policy, then it is in the position of being able to collect the death benefit and redeem the equity previously held by the deceased owner. The life insurance becomes a financing tool by allowing the business to make periodic payments in advance of the day when the proceeds will be necessary. Businesses also use life insurance as a means of replacing a key employee[4] whose untimely death might significantly impact the business' profitability.

Income Tax Traps for Employer-Owned Life Insurance

There are three exceptions to the general rule that can cause the death benefit on life insurance to be includable in gross income:

- First, the exclusion from income under Code Sec. 101 does not apply if the insurance policy was acquired in a "transfer for value" under Code Sec. 101(a)(2).

  For example: A owns a life insurance policy on its own life and names members of its family, as beneficiaries. A transfers the life insurance policy to its employer, a corporation, in exchange for the cash surrender value of the policy. The employer has now acquired the policy as part of a "transfer for value." Employer pays the premiums for the remainder of A's lifetime. When A dies, the employer will recognize gross income to the extent that the life insurance proceeds exceed the total payments (employer's basis in the policy).

  The "transfer for value" rule can be avoided if the statute is literally followed. There are three exceptions to the rule. The death benefit associated with a life insurance policy will not be included in gross income if the policy is transferred to (a) the insured, (b) a partner of the insured, or (c) a partnership in which the insured is a partner.
- Second, the exclusion from income does not apply if an employer is the original purchaser of a life insurance policy on the life of an employee without permission. If the employee did not receive notice and sign a waiver under Code Sec. 101(j), then the death benefits received by the employer on such company-owned life insurance (COLI) would be taxable.[5]
- Third, C Corporations owning life insurance may not be subject to ordinary income tax on death benefits but may be subject to certain excise taxes and penalties.
  - To the extent that the proceeds of COLI are not necessary for the payment of debt or the complete redemption of the deceased shareholder's equity, they can represent a taxable dividend, or if they are retained, they can be subject to a penalty on unreasonable accumulation of earnings. Code Sec. 302 provides that a complete redemption of a shareholder's equity will generally be treated like a sale or exchange. The estate of a deceased shareholder gets a step-up in basis on their equity under Code Sec. 1014. As a result, if a redemption qualifies as a complete redemption of the shareholder's equity interest there would be no gain to the seller. If, however, the redemption did not qualify under Code Sec. 302, or it was deemed to be only a partial redemption, then the entire payment could be deemed to be a dividend. However, to the extent that the partial redemption covers death-related expenses, then Code Sec. 303 can allow the payee to avoid dividend treatment.
  - To the extent that the insurance proceeds are retained and are not necessary to cover debt or shortfalls in earnings. Code Sec. 531 *et. seq.* may require the taxpayer to self-assess a 20% accumulated earnings penalty on funds that are unreasonably retained and not paid as a dividend.
  - Large corporations need to be concerned about large amounts of non-taxable (book) income. Although the Corporate alternative minimum tax (AMT) was repealed several years ago, for years beginning after 2022, a 15% Corporate AMT under Code Sec. 55 is imposed on adjusted financial statement income (AFSI) in excess of $1 billion. Although the proceeds of life insurance may not represent taxable income, they do represent AFSI.

S Corporation Traps for Employer-Owned Life Insurance

Subchapter S Corporations owning life insurance may not have to worry about the Corporate AMT, but they have an income tax trap of their own when it comes to life insurance policies.

S Corporations are generally required to separately state items of income, deduction, and credits due to the fact that these items flow through the S Corporation income tax return and are reportable by their shareholders. Under Code Sec. 1367, the earnings and profits of S Corporations increase the tax basis of each shareholder. Simultaneously, under Code Sec. 1368 the earnings and profits of an S Corporation are also tracked as part of the accumulated adjustments account (AAA). Taxable income of the S Corporation increases AAA and basis. Losses and distributions of the S Corporation decrease AAA and basis. If the distributions to shareholders do not exceed either AAA or the shareholder's basis, then the distributions are tax-free.

Tax-exempt income earned and non-deductible expenses paid during years that the corporation is operating under Subchapter S do not impact AAA. Instead, these items are separately tracked as part of the S Corporation's Other Adjustments Account (OAA). As a result, non-deductible insurance premiums under Code Sec. 264 are charged to (decrease) OAA, and the tax-exempt death benefits received under Code Sec. 101 are credited to (increase) OAA.

If the corporation operated at any time under Subchapter C, then the earnings and profits generated during those years are segregated from the years in which the corporation has operated under Subchapter S. The C Corporation earnings and profits are tracked separately as part of the corporation Accumulated Earnings & Profits (AEP).

The ordering rules of Code Sec. 1368 create an ordering that impacts all distributions from S Corporations. Under Code Sec. 1368, distributions are charged as follows:

- First, 100% against the balance of the AAA. This distribution will be income tax-free to the recipient if they have basis;
- Second, 100% against the balance of any Previously Taxed Income (PTI) (*i.e.*, S Corporation earnings accumulated prior to 1983). This distribution will be income tax-free to the recipient if they have basis;
- Third, if the company operated as a C Corporation, 100% against the balance of all AEP. Since no individual has paid income tax on these amounts, these distributions will be taxed to the recipient as qualified dividends;
- Fourth, 100% against the balance of the OAA. This distribution will be income tax-free to the recipient if they have basis; and
- Finally, once all of the above have been distributed then any distribution will be treated as a return of capital (possibly subject to a capital gains tax).

The problem for S Corporation shareholders where the corporation is the owner and beneficiary of a policy of life insurance is that the tax-free OAA is locked in under several layers of earnings. To the extent that the corporation redeems the deceased shareholder's equity, the insurance is available and utilized with relative ease. However, if the surviving shareholders wished to distribute the proceeds and purchase the equity personally, then the hurdles may be insurmountable. By the time the shareholders are eligible to receive any OAA, they may have little or no income tax basis remaining in their shares. If the distribution of OAA exceeds the shareholder income tax basis, then that excess will be taxable to the shareholders as a capital gain.

Income Tax Issues for Employer-Financed Life Insurance

- Entity (equity)-owned life insurance. Where premiums are paid by a corporation or a partnership on insurance on the life of an equity owner, and the entity is not the beneficiary of the death benefit, then the payment of the premiums may represent some form of distribution or dividend. These deemed distributions represent an economic benefit that are includable in gross income under Code Sec. 61(a)(1).
- Employee-owned life insurance. Where premiums are paid by an employer on insurance on the life of an employee, and the employer is not a beneficiary of the death benefit, then the payment of the premiums may represent some form of compensation or taxable fringe benefit that is taxable to the employee. This economic benefit is generally deemed to be compensation under Code Sec. 83.

The economic benefit attributable to either equity- or employee-owned life insurance is generally measured by the Internal Revenue Service (IRS) in published U.S. Life Tables. More about the tables in a minute.

Code Sec. 79—Group Term Life Insurance

Many employers view life insurance as a fringe benefit that will allow them to attract and retain employees with dependents. Health insurance providers typically include some amount of life insurance as part of the group health insurance benefit plans that are marketed to employers. These plans will frequently provide a small amount of life insurance on the life of the employee, the spouse of the employee, and, many times, each dependent of the employee.

Insurance companies are generally more profitable if they are able to insure a large number of people at the same time. This allows them to spread the risk of death over a large population and thus pass a portion of the cost savings to the consumer in the form of lower premiums. Group plans generally benefit from these cost savings.

Code Sec. 79 permits employers to provide up to $50,000 of tax-free life insurance coverage to each of their employee. If the employer provides more than $50,000 (on a non-discriminatory basis) to its employees, then the cost of the policy may be income to the employee. If the employee shares in the cost of the insurance, then Code Sec. 79 only requires the employer to include the amount the excess portion of the cost paid by the employer in the employee's gross income. Code Sec. 162(a) generally permits employers to deduct the portion of the premiums that it pays toward the group plan that provides benefits under Code Sec. 79 if they are ordinary and necessary expenses of the trade or business.[6]

Executive Bonus Life Insurance

Another fringe benefit involving life insurance is executive bonus life insurance. Under this plan, the employee is the owner of the insurance contract and the employee controls the naming of the beneficiary and any side fund related to the policy. The employer covers the cost of the premiums by periodically giving the employee cash bonuses. The cash bonuses are generally deductible to the employer and taxable as wages to the employee, subject to Code Sec. 162. If the employee leaves the employer, there are no strings attached to the policy. The employee takes the policy and any cash surrender value associated with the policy.

Split-Dollar Compensatory Life Insurance

In an effort to reduce the income tax inclusion due to the employee, insurance marketers have devised a method for dividing (*i.e.*, splitting) the ownership of employee life insurance between the employer and the employee, thus creating "Split-Dollar" contracts. Under a Split-Dollar arrangement, the employer would generally pay all the premiums on a permanent contract of life insurance. The employer would retain the right to be reimbursed for the premiums paid out of the accumulating cash value within the policy's side fund. The employee would retain the right to name the beneficiary of the amount of the side fund and/or death benefit in excess of the premiums paid.

The employer would not be eligible for a deduction of any portion of the premiums paid because the employer's portion of the arrangement is viewed as an "open transaction," meaning all the events have not occurred, which will allow us to determine whether the employer is going to be reimbursed. It is possible in a Split-Dollar arrangement that the employer could be reimbursed 100% of the amount of the premiums paid. The employer's contributions to Split-Dollar contracts should be recorded as receivables on the employer's financial statements.

Under Code Sec. 61(a)(1), gross income broadly includes compensation for services rendered, including fringe benefits and similar items. Prior to 2002, the U.S. Supreme Court[7] had broadly ruled that gross income included the value of all economic benefits provided by the employer. In an attempt to quantify the value of the economic benefit of life insurance, the IRS published a table known as P.S. 58, which set out the term costs of life insurance.[8] Employers were allowed to use "the lower of" the P.S 58 rate or the insurance company's lower published term rates in determining the economic benefit (value) of the payment. This "lower of" option led to the widespread use of artificially low rates being published by the insurance companies, which in reality were not really available to the public.

In 2001, Notice 2001-10[9] revoked the use of P.S. 58 and substituted a new table—"U.S. Life Table 2001." Additionally, the IRS limited "the lower of" option to the rates of term policies, which the carrier regularly sold through normal distribution channels. Furthermore, the IRS announced its intention to publish guidance that would base the future taxation of the economic benefits of "Split-Dollar" under the principles of Code Sec. 7872, which applied to interest-free loans. Regulations under Reg. §1.61-22 were published on September 11, 2003, which required the employee to include in income the interest-free loan value of the cumulative premiums paid by the employer as one method of valuing the economic benefit of employer-provided life insurance.[10]

The new rules have caused Split-Dollar arrangements to lose much of their luster. While they remain viable for young employees, the income tax inclusion required under the tables can far exceed the employer's out-of-pocket costs after the employee reaches 60 years of age.

Gift and Estate Tax Considerations of Life Insurance

As we have seen, the proceeds of life insurance might be accessed income tax-free by the owner of the policy during lifetime, or if it is properly structured, it may be income tax-free to beneficiaries at the insured's death. The potential estate taxation of life insurance is a separate issue.

Under Code Sec. 2042, a decedent's gross estate includes the value of any death benefits received by the decedent's estate, as well as any death benefits received by other beneficiaries where the decedent possessed any "incidents of ownership" in such policy at the time of death.[11] Incidents of ownership are generally interpreted to mean the power to impact either the cash value of the policy or the death benefit. In other words, if, during life, a person had the right to borrow against the cash surrender value of the policy or the power to change the beneficiaries, then that person would be considered to possess incidents of ownership over the policy on its life.

Gift/Estate Tax Trap—Goodman's Triangle

Where the policy owner and the beneficiary are different persons, there could be a taxable transfer in the form of a taxable gift. This trap is commonly referred to as Goodman's Triangle.[12]

The underlying rationale is that the owner of the policy has the right to control the beneficiary. If the owner names someone other than itself as the beneficiary of a policy on the life of a third person, then the owner may be deemed to have made a taxable transfer in the form of a gift, if the owner and the beneficiary are both alive at the death of the insured. Similarly, if the owner is the insured, or dies before the insured, then the transfer may be deemed to be subject to estate tax, upon the death of the owner. The owner's death terminates the ability to change the beneficiary and results in a transfer of the then value of the policy.

The Gift and Estate Tax Marital Deduction

Where the named beneficiary of the policy is the spouse of the owner, Goodman's Triangle becomes somewhat irrelevant. A gift or a transfer at death payable to one's surviving spouse is eligible for unlimited marital deduction for both gift and estate tax purposes under Code Sec. 2056.

Naming the owner/insured's spouse as the 100% beneficiary of any and all life insurance may at first blush seem to be the perfect answer to avoiding both income and estate tax on the death benefit. The marital deduction avoids gift and estate tax at the first death. However, where a surviving spouse has significant wealth of its own, paying the life insurance death benefit outright to the surviving spouse may create estate tax implications at the second death. This inclusion of the death benefit at the second death can be avoided if the proceeds are payable to a trust for the benefit of the spouse, similar to a Credit Shelter Trust.[13] If the trust is properly structured and does not give the surviving spouse a general power of appointment, then the proceeds can be made available to the spouse and escape tax at the second death.

The key to excluding life insurance from potential estate taxation requires the proper structuring of both the ownership during life and payment of the death benefits. The solution to both issues can frequently be found in using Irrevocable Life Insurance Trusts (ILITs).

Irrevocable Life Insurance Trusts

Irrevocable trusts created for the benefit of persons other than the Grantor (*i.e.*, spouse and/or children) are generally excluded from the estate of the Grantor, provided that the Grantor does not "retain an interest" in the trust under Code Sec. 2035, 2036, or 2037.[14] Even though the Grantor of the trust may dictate the original terms of the trust that control the ultimate disposition of the assets, the assets of the irrevocable trust will not be includable in the Grantor's estate does not retain an interest in the trust. In addition, if the beneficial interests in the trust are structured like a Credit Shelter Trust, then the proceeds can grow outside of the includable gross estate of the surviving spouse. Finally, if the Grantor's Generation Skipping Tax Exclusion amount can be allocated to the trust, then the proceeds may grow outside of the includable gross estates of succeeding generations as well.

Life insurance is an unusual asset in as much as it is generally worth only a modest amount, while the insured is living. Its true value does not arise until near the time of death of the insured.

There are several potential traps that need to be navigated when it comes to forming and funding ILITs. As regards formation:

- The Grantor (creator) of the trust should never be a trustee;
- The Grantor of the trust should not have the right to borrow the policy cash value from the trust or substitute assets that include the insurance policies;
- If a pre-existing policy is transferred (either through gift or assignment) to the ILIT, Code Sec. 2035 may cause the full death benefit value of the policy to be includable in the estate of the insured if the insured dies within three years of the transfer of the policy to the trust. This can be easily avoided if the ILIT is the initial purchaser or owner of the policy;
- Although the policy might be purchased to help the family provide liquidity for the payment of Federal or State Estate (Inheritance) Taxes, the trust should never direct or require the Trustee to use the proceeds of the trust to pay for such expenses. Instead of requiring the Trustee to use the funds, the trust agreement should permit the Trustee to either purchase assets from the estate of the deceased taxpayer or permit the Trustee to lend funds to the executor of the estate. The loan should be fully documented as a loan and bear a market rate of interest in order to avoid having the amount being deemed includable or being a deemed to be a potential gift.

As regards the ongoing funding of the ILIT, it should be recognized that the trustee may need to pay future premiums on the life insurance policies during the lifetime of the insured.

- The insured should not pay the premiums directly;
- Transfers of cash should be made to the trustee: the trustee should deposit the cash in a bank account in the name of the ILIT, and the trustee should then pay the premiums directly;
- The transfers of cash to the trust are gifts. In order to allow those gifts to qualify for the annual gifts tax exclusion under Code Sec. 2503(b), the trust agreement should be structured to provide that the gifts are present interest gifts. This is typically done by requiring the trustee to notify the beneficiaries of the additions to the trust and then permitting the

beneficiaries the right to withdraw their portion of the addition from the trust. This withdrawal right was first made famous in the court case, *Crummey*.[15]

- If the withdrawal right is greater than $5,000 or 5% of the value of the trust, then care must be taken in how this right is permitted to lapse. The lapse of a power greater than "5 and 5" is deemed to be a gift by the powerholder in favor of all the other trust beneficiaries under Code Sec. 2514. This can be avoided by restricting the lapse to the greater of $5,000 or 5% and by permitting the amount in excess to "hang" or continue to be available for withdrawal until a subsequent year when an additional 5 and 5 is permitted to lapse again.[16]
- Although Crummey withdrawal rights can qualify for the present interest gift tax exclusion, there is no provision either in the statutes or in case law that would allow the withdrawal rights to qualify for an annual generation-skipping tax (GST) exclusion under Code Sec. 2642(c)(3) as a "Nontaxable Gift." As a result, GST exemption must be allocated to all gifts that might otherwise qualify under Crummey as Code Sec. 2503(b) exclusion gifts.
- Consideration should be given to gifting income-producing assets to the ILIT. This upfront gift may exceed the withdrawal powers and necessitate the filing of a gift tax return to apply for Estate Tax Credit and allocate GST exemption, but in the long run, it may save gift tax and GST, since the income generated on the assets may avoid the necessity for making future gifts.[17]

Holding life insurance policies inside of ILITs are the key to getting the best of both worlds, exclusion of the policy from the estate of the insured and the potential exclusion of the death benefits from the estates of successive generations, as well.

Conclusion

Life insurance is an important tool in the tax practitioner's toolbox for clients of all ages and walks of life. Young families need protection from untimely deaths in order to provide for the payments of mortgages, the high cost of education, or merely to replace a lost stream of income. Businesses may see life insurance as a means to attracting and retaining quality employees. Illiquid businesses need insurance protection to replace key employees or avoid the liquidation of the business merely to fund buy-outs of deceased equity owners. Wealthy clients may need insurance protection to replace assets lost to estate taxes.

Appreciating the fact that life insurance may be part of the solution is important, but knowing how to structure the ownership of the life insurance policy, how to pay future premiums, and how to receive and hold the beneficial interest for those that survive is equally important.

ENDNOTES

1 Code Sec. 264.

2 Code Sec. 101.

3 The term chronically ill is defined in Code Sec. 7702B(c)(2).

4 Frequently referred to as "Key-Man" or "Key Person" life insurance.

5 As discussed in Part I, insurer will generally limit the amount of life insurance that a person may purchase and own to their net worth and any income stream that they might generate and therefore need to protect. When a third party such as an employer purchases COLI on the life of an employee, they theoretically limit that employee's ability to personally purchase life insurance in the future.

6 LTR 8038207 (June 19, 1980); *Elm City Cotton Mills*, 5 BTA 309, Dec. 1874 (1926), *acq.*, VI-1 CB 2 (1926); and *W.M. Ritter Lumber Co.*, 30 BTA 231, Dec. 8491, *acq.*, XIV-2 CB 19 (1935).

7 *P.J. Lo Bue*, SCt, 56-2 USTC ¶9607, 351 US 243, 246, 76 SCt 800; *J.H. Smith*, SCt, 45-1 USTC ¶9187, 324 US 177, 181, 65 SCt 591 (1945); *Old Colony Trust Co.*, SCt, 1 USTC ¶408, 279 US 716, 729, 49 SCt 499 (1929).

8 The rates set forth in this table were issued as part of Rev. Rul. 55-747, 1955-2 CB 228 (January 1, 1955) and allow an employer and an employee to compute the economic benefit of life insurance prior to the issuance of Notice 2001-10, 2001-1 CB 459.

9 In Notice 2001-10, 2001-1 CB 459 (January 9, 2001), the IRS revoked the P.S. 58 rates and replaced them with what became known as the Table 2001 rates.

10 A detailed discussion of economic benefit rules under the loan regime are beyond the scope of this column.

11 Incidents of ownership generally include (1) the right to change the beneficiary of the policy, (2) the right to borrow any cash value accumulating inside of the insurance policy, and (3) the value of any reversionary interest in either the policy or the proceeds that exceeds 5% of the value of the policy immediately before death.

12 The "Goodman Triangle" is a common trap for the unwary. It is based on an old Federal District Court decision, *A.F. Goodman*, CA-2, 46-1 USTC ¶10,275, 156 F2d 218. In *Goodman*, the Court held that where the policy owner and the beneficiary are different persons, there could be a taxable transfer in the form of a gift. The Court stated that "at least two points on the triangle should always be the same."

13 The estate planning documents (*i.e.*, Wills and Trusts) of many married persons are structured to set aside an amount at the death of the first to die that is equal to the lower of the Federal or the State Estate Tax exemption or credit. This tax sheltered amount, typically referred to as the Credit Shelter amount, will usually provide access to income and principal for the surviving spouse, but it will be structured so as to avoid inclusion in the gross estate of the surviving spouse.

14 An in-depth discussion of these provisions is beyond the scope of this column. Code Sec. 2035 includes certain transfers made within three years of death; Code Sec. 2036 includes certain transfers where the Grantor retained the right control of the enjoyment of assets; Code Sec. 2037 includes transfer taking effect at the Grantor's death.

15 *D.C. Crummey*, CA-9, 68-2 USTC ¶12,541, 397 F2d 82.

16 For an in-depth discussion of Crummey Powers and Hanging Powers, *see* Brian T. Whitlock, *Federal Gift Tax Returns: Managing Withdrawal Powers*, TAXES (CCH, August 2019, p. 39).

17 For an in-depth discussion of the benefits of Funding ILITs, *see* Brian T. Whitlock, *2020 Foresight: Time to Fully Fund ILITs* (CCH, October 2019, p. 33).