THE NAUTILUS GROUP®

GUIDEPOST

# Transfer of a Life Insurance Policy to or from a Business

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Transferring ownership of a life insurance policy is full of challenges. First, the policy must be valued properly. Valuation depends on many factors, including the transfer type, the policy type, the length of time the policy has been in force, and the current health status of the insured. After a policy's value is determined, consideration must be given to the income tax consequences that will result from changing policy ownership. When a policy is being transferred to or from a business, the income tax liability associated with the transfer will depend on the entity (i.e., corporation, partnership, LLC). The following summarizes valuation and income tax considerations upon the transfer of a life insurance policy to or from a business.

## Determining a policy's fair market value

When transferring a policy to a business, whether as a capital contribution or by purchase, it is necessary to determine the policy's fair market value (FMV). 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.

Revenue Procedure 2005-25 provides that the FMV of a policy distributed ***from*** a business is the greater of:

- The policy's modified interpolated terminal reserve (ITR) value; or
- 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 (UL) 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 account of 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. The formula set forth in Rev. Proc. 2005-25, however, is not a substitute for an independent qualified appraiser to determine the policy's FMV, as the qualified appraiser will review all factors when determining the policy's FMV, such as the insured's health at the time of valuation.

## Tax implications

### Income tax considerations

The transfer of a policy to or from a business could create income tax liability for the business or for the insured. The income tax considerations of transferring property, including a life insurance policy, to and from a business are summarized in the following table.

| Taxation of Income on Transfers to or from Various Business Entities | | | |
|---|---|---|---|
| | C Corporation | S Corporation | Partnership/LLC[1] |
| Transfers of Appreciated Property to Business | Gain[2] 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 from Business | Dividends are taxable at a maximum of 23.8% (currently) to shareholder to the extent of earnings and profits (E&P).<br><br>Dividends are not deductible. | Distributions from AAA (if former C corporation) - not taxable but reduces shareholder's basis.<br><br>Distributions from E&P (if former C corporation) does not reduce basis but is taxable to shareholder.<br><br>Distributions of basis are not taxed to shareholder, but basis is reduced by distribution.<br><br>Distributions in excess of basis are capital gain. | Distributions of basis are not taxed to partner, but basis is reduced by amount of distribution.<br><br>Distributions that exceed partner's basis are subject to capital gain. |
| Distributions of Appreciated Property<br><br>– Business Taxation | Gain is taxable to corporation.[3]<br><br>Property distributed as compensation is deductible, if reasonable. Gain is offset by deduction.<br><br>Property distributed as dividend is nondeductible to corporation. | Gain is taxable to shareholders.[3]<br><br>Property distributed as compensation is deductible, if reasonable. Gain is offset by deduction.<br><br>Built-in gains (recognized from sale or distribution of prior C corporation property) taxable to S corporation at highest C corporation rate during built-in gains recognition period (currently 5 years). | Gain is generally not recognized on distribution; it is recognized at the time of sale by distributee partner. |
| Distributions of Appreciated Property<br><br>– Owner / Employee Taxation | Taxable amount is property's FMV.<br><br>If dividend, taxable at a maximum of 23.8% (currently).<br><br>If compensation, taxed as ordinary income at the shareholder's marginal rate. | Compensation – taxable at shareholder's marginal rate.<br><br>Distributions from AAA (if former C corporation) – not taxable but reduces shareholder's basis.<br><br>Distributions from E&P (if former C corporation) does not reduce basis but is taxable to shareholder.<br><br>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.<br><br>Partner's basis is reduced by distribution. |

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1 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.

2 Gain on appreciated property is its Fair Market Value (FMV) in excess of tax basis (net cost).

3 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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