Contemporary Uses for Life Insurance in Estate Planning

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Presents

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By:

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Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

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Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award. Mr. Redd was the principal draftsman of the recently enacted Missouri Family Trust Company Act.

Mr. Redd is an elected member of The American Law Institute and a Fellow of The American College of Trust and Estate Counsel (Past Missouri State Chair; Past Regent; Estate and Gift Tax Committee; and Fiduciary Litigation Committee). He was an adjunct professor of law (Estate Planning) at Northwestern University School of Law for fifteen years. He serves as Co-Chair of the Editorial Advisory Board of, and writes a regular column in, TRUSTS & ESTATES magazine. In 2018, he was inducted into the Estate Planning Hall of Fame® by the National Association of Estate Planners and Councils. Mr. Redd is listed in The Best Lawyers in America and is "Band 1" ranked by Chambers and Partners in their High Net Worth guide. He frequently writes and lectures nationally on topics in the trusts and estates field.

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I. Proper Structuring of Beneficiary Designations

While most clients understand the purposes and utility of life insurance, some fail properly to designate their intended beneficiaries.

A. The Estate as Beneficiary

Most insurance contracts provide for takers in default if the owner fails to designate a beneficiary. Typically, the default language provides that the death proceeds shall be paid to the insured's estate. Paying the proceeds to the estate is almost always a poor option. Life insurance proceeds in the estate of the insured will be subject to the insured's creditors' claims when state law would in most cases otherwise protect them from such claims. In addition, proceeds passing to the insured's estate will be included in his or her gross estate for federal estate tax purposes. Internal Revenue Code of 1986, as amended, ("IRC") § 2042(1). Furthermore, some states calculate a spouse's elective share based on the amount of probate assets only. *See, e.g.*, Md. Code Ann., Est. & Trusts § 3-203; *accord Karsenty v. Schoukroun*, 959 A.2d 1157 (Md. 2008) (holding that nonprobate transfers are includible in the "net estate" under Maryland law only when equity requires, not solely because a spouse died with a revocable trust naming the daughter the sole beneficiary of the residuary estate). In sum, allowing proceeds to be paid to the estate can result in a host of problems for clients and their survivors.

B. Individuals as Beneficiaries

In many cases, clients wish to designate a surviving spouse, children or other relatives as beneficiaries of a life insurance policy. In the case of a surviving spouse, simply designating the spouse by name is satisfactory. Alternatively, one might designate "my spouse, if any," although a life insurance company may not accept such a designation due to reluctance to become involved in or be responsible for a determination of who, if anyone, qualifies as "my spouse."

Regarding the designation of children as life insurance beneficiaries, estate planners should counsel their clients on the difference between *per stirpital* and *per capita* divisions and distributions. If the client's intent is to benefit only his or her children who are living at the client's death, *per capita* designations are appropriate. Here are some examples:

➔ "One-third to Bryan Smith, one-third to Sarah Smith, and one-third to Ian Smith."

➔ "In equal shares to Bryan Smith, Sarah Smith, and Ian Smith."

➔ “To my children who survive me in equal shares.”

Alternatively, if the client’s intent is to benefit each child’s branch of the family equally, not just the living children, the insured will wish to make a *per stirpital* designation:

➔ “To my descendants who survive me, *per stirpes*.”

The estate planner should review the insurance policy contract before making a *per stirpital* beneficiary designation because it can present difficulties depending on the insurance company. For example, a given company may not accept “*per stirpes*” language as part of a designation because it does not want to assume any responsibility for determining the identity and/or generation assignment of the insured’s descendants at his or her death.

All of the above pertains to, and assumes that the client is, designating the primary beneficiary or beneficiaries. Whenever one or more natural persons are being named as primary beneficiaries, the desirability of designating one or more contingent or secondary beneficiaries must not be overlooked. The ultimate goal is to have legally effective beneficiary designations designed to work in a variety of contingencies so that the default beneficiary under the policy contract (the insured’s estate) does not take – which would thwart the client’s intent and cause one or more of the undesirable results described above.

Additional considerations involving life insurance beneficiary designations include whether it is desirable and/or possible under the policy provisions to provide that one or more contingent or secondary beneficiaries are to receive specified dollar amounts or percentages of the death benefit. If such an approach is desirable and possible, it is important to ensure, when designing the beneficiary designations, that the entire death benefit is effectively disposed of.

C. Naming a Trust

Designating a trust as the beneficiary of a life insurance policy is often an excellent option. For example, with an outright distribution to descendants, *per stirpes*, the likelihood is increased that a minor beneficiary could receive insurance proceeds. In some cases, this could necessitate a guardianship or conservatorship proceeding to be opened for the minor, which would increase delays and costs. *See* Brody & Jansen, *In Honor of Heckerling’s 50th Anniversary, and with Apologies to Paul Simon, There Must Be 50 Ways to Make Insurance Planning Mistakes*, HECKERLING INSTITUTE ON ESTATE PLANNING (2016). Assuming the trust instrument contains all necessary provisions to effectuate a *per stirpital* division among descendants’ shares at the appropriate time, the beneficiary designation language could read as follows:

➔ “To the then acting Trustee or Trustees under the John Q. Adams Revocable Trust, dated September 1, 2012, as amended.”

If there is more than one trust to be created under a client’s Will or revocable trust instrument, one that is exempt from generation-skipping transfer tax and one that is not, for example, it will be important for the trust instrument to contain detailed directions regarding how trust property, including insurance proceeds, is to be allocated between such trusts. Including such detailed directions in the beneficiary designation should be avoided whenever possible. A Trustee is far better suited to interpret and implement detailed allocation provisions than a life insurance company.

More general designations, such as "to my issue, in trust," may be insufficient to avoid a challenge by a potential beneficiary or a petition for instruction or interpleader action by the insurance company. *See Sun Life Assurance Company of Canada (U.S.) v. Gruber*, 2007 WL 4457771 (S.D.N.Y. 2007).

A beneficiary designation in favor of a trust may be an advantageous approach for additional reasons. First, insurance proceeds held in trust, for as long as such arrangement lasts, and assuming the trust has appropriate dispositive provisions, will usually be sheltered from claims of a beneficiary's creditors and, in the event of a dissolution of marriage, claims of his or her spouse or former spouse. Second, the trust provisions can easily be structured to prevent inclusion of the value of the trust property in the beneficiary's gross estate.

D. Other Precautions

Planners should be aware of unintended gift tax consequences when different individuals are named as owner, insured and beneficiary. If Father is the owner of a policy, Mother is the insured and Daughter is the beneficiary, there may be a gift of the policy proceeds to Daughter by Father upon Mother's death. *See Estate of Goodman v. Comm'r*, 156 F2d 218 (2d Cir. 1946); Brody & Jansen, *supra.*

II. Using Life Insurance In Business Succession Planning

A. Allocating All Business Equity to Insiders and Life Insurance Proceeds to Outsiders

A common problem for a business owner is adequately providing for children who are not active in the owner's business when the business owner chooses to leave all business equity to those who are active in the business. One solution to this problem is to "create" additional assets by securing insurance on the owner's life. If the business owner has a living spouse, an available slight variation on this theme would be to secure second-to-die coverage on the lives of the owner and spouse. Depending on the type of coverage obtained, the maturity of the children and the owner's dispositive desires, the owner might designate the surviving spouse, the Trustee of a post-death revocable trust, the Trustee of an irrevocable trust or some or all of the outsiders to receive the insurance proceeds, while the insiders receive full ownership of the business. The insurance policy could be placed in an irrevocable insurance trust to avoid subjecting the value of the proceeds to estate tax in the estate of either parent. There are many good ways to refine this life insurance-based strategy, but the common thread is that this approach offers the business owner the means with which to satisfy his or her familial obligations to both the insiders and the outsiders as well as to address the needs of the children and the business in a unified and equitable manner. This plan assumes, of course, that the health of both or at least one of the parents allows the necessary life insurance coverage to be obtained at reasonable rates.

This estate disposition method recognizes that the business interest should be worth more to the insiders, especially if they have control, then to the outsiders and that the outsiders probably would prefer to receive cash or marketable assets rather than an interest in a closely-held business in which they are inactive. It also separates the business and financial aspects of the insiders' lives from the business and financial aspects of the outsiders' lives, removing a substantial impediment to a good relationship among the children and promoting family harmony.

B. The Buy-Sell Agreement

1. <u>In General</u>. A buy-sell agreement is a contract among the owners of an entity, or among the owners and the entity itself, under which: (a) the class of potential transferees of ownership interests in the entity is limited to those persons designated in the agreement; and (b) ownership interests in the entity are to be purchased and sold only: (1) at a price set in or under the provisions of the agreement; and (2) upon the occurrence of a specified triggering event (*e.g.*, (i) an owner's death; (ii) dissolution of an owner's marriage; (iii) an owner's reaching a designated age; (iv) an owner's becoming disabled; (v) an owner's voluntary transfer or attempted transfer of business equity outside the class of permissible transferees under the agreement; (vi) an owner's bankruptcy, insolvency or an involuntary transfer or attachment of an owner's assets; (vii) receipt from an outside party of an offer to purchase an owner's interest; (viii) an owner's voluntary withdrawal; or (ix) termination of an owner's employment with the entity) (a "triggering event"). Permissible transferees under a buy-sell agreement typically include the other owners of the entity, the entity itself, various specified members of an owner's family and trusts for an owner's family members.

One of the primary benefits of a buy-sell agreement is that it may alleviate disputes among the owners regarding transfers of business interests (a benefit that cannot be overstated in the family context). Additionally, a buy-sell agreement may establish the value of a deceased owner's interest for estate tax purposes if the agreement satisfies the requirements of Treas. Reg. § 20.2031-2(h) and IRC § 2703.

2. <u>Use of Life Insurance With Different Types of Buy-Sell Agreements</u>. One type of buy-sell agreement is a cross-purchase agreement, which provides that, upon the occurrence of a triggering event, the continuing owners will acquire (or will have the right to acquire) the deceased owner's interest at a purchase price that is determined under the agreement. An advantage associated with using a cross-purchase agreement is that the income tax basis of the surviving owners in the business interests they purchase is increased by the price paid. After an owner's death, the deceased owner's unmatured policy(ies) on the lives of the surviving owners should be structured to pass to them or to the entity. The share of equity in the business of each surviving owner increases after the death of one owner, so the policy(ies) formerly held by the deceased owner can be used to fund the purchase of the other owners' interests upon their respective deaths. *See* Mancini, *Cutting the Gordian Knot of Insurance Transactions*, 53rd HECKERLING INSTITUTE ON ESTATE PLANNING (2019).

Another type of a buy-sell agreement is a redemption agreement, under which, upon the occurrence of a triggering event, the entity redeems the owner's interest at a price specified or provided for in the agreement. In general, a redemption agreement is mechanically simpler to implement than a cross-purchase agreement. If life insurance-based funding is to be used, with a redemption agreement, unlike a cross-purchase agreement, only one life insurance policy for each business owner is needed, and there is only one owner and payer of premiums with respect to all life insurance policies. When the entity purchases the owner's interest, the value of the other owners' interests is increased, but their basis remains unchanged.

A third type of buy-sell agreement, sometimes referred to as a hybrid agreement or wait-and-see agreement, combines aspects of both the cross-purchase agreement and the redemption agreement by giving the entity the primary right, upon the occurrence of the triggering event, to acquire the deceased owner's interest and permitting or requiring the surviving owners to redeem the deceased owner's interest to the extent that the primary right is not exercised. Alternatively, the surviving owners may have the right to purchase some or all of the deceased owner's interest, and any interest not purchased by the surviving owners may be purchased by the entity. Mancini, *supra*.

In carrying out the purchase of the exiting owner's business equity, life insurance often plays a major role in providing the necessary liquidity to the purchaser. This is especially true when the purchaser must acquire the exiting owner's interest through a lump sum purchase. The other owners (in the event of a cross-purchase) or the business (in the event of a redemption) will obtain a policy (or policies) of insurance on the life of the subject owner naming the other owners or the business entity, as the case may be, as both the owner(s) and the beneficiary(ies) of the policy(ies). Upon the death of the insured, the surviving owners or the entity, as the case may be, receive the life insurance proceeds and use those proceeds to purchase the decedent's business equity from his or her estate or post-death revocable trust.

To avoid inclusion of the value of the life insurance proceeds in the insured's estate for federal estate tax purposes, the insured must not be the owner of any policy of insurance on his or her life. Instead, a given owner should be both the owner and beneficiary of the policy or policies insuring the life or lives of the other owner or owners, or the business should be named as the owner and the beneficiary. Even if the decedent is the controlling shareholder of a corporation owning a policy of insurance on his or her life, the corporation's incidents of ownership will not be attributed to the decedent through his or her stock ownership to the extent the proceeds of the policy are payable to the corporation. Treas. Reg. § 20.2042-1(c)(6).

III. Income Tax Traps Involving Life Insurance Policies

A. Transfer for Value Rules

Transfers of life insurance policies for consideration by the owner of the policy are subject to the transfer for value rules under IRC § 101(a)(2) unless certain exceptions apply. Under IRC § 101(a)(2), the transfer of a life insurance policy for consideration will subject the death proceeds to ordinary income at the insured's death. *See Mancini, supra*. However, the beneficiary of the life insurance policy may reduce the amount subject to tax by: (1) the amount of consideration paid for policy; and (2) the premiums and other amounts (*e.g.*, interest on most indebtedness) subsequently paid by the transferee. Treas. Reg. § 1.101-1(b)(1), -1(b)(5), Ex. 1.

1. <u>Exceptions</u>. The transfer for value rule is subject to significant exceptions. The transfer for value rule does not apply if the transferee's basis in the policy is determined, in whole or in part, by reference to the transferor's basis. IRC § 101(a)(2)(A); Treas. Reg. § 1.101-1(b)(1) (the "carryover basis exception"). This may occur, for example, when a policy is transferred from a corporation to another corporation in a tax-free reorganization. Treas. Reg. § 1.101-1(b)(5), Ex. 2.

The transfer for value rule also does not apply if the transfer is to the insured, a partner of the insured, to a partnership in which the insured is a partner or to a corporation in which the insured is a shareholder or officer. IRC § 101(a)(2)(B); Treas. Reg. § 1.101-1(b)(1) (the "related party exception"). When considering transfers to a partnership in which the insured is a partner, the IRS looks for a business purpose to find a valid partnership. The IRS has ruled that the transfer of a policy from a trust to a limited partnership in which the insureds were limited partners would not constitute a transfer for value. PLR 200111038; *see Mancini, supra*. Also, the IRS ruled in PLR 9625013 that this exception should also apply to limited liability companies.

2. <u>Other Considerations</u>. If a life insurance policy is transferred for valuable consideration, but is then subsequently transferred in a manner that meets one of the exceptions to the transfer for value rule, the death proceeds will lose the "taint" of the transfer for value rule and be excludable from gross income. Treas. Reg. § 1.101-1(b)(2), (3); *see also Mancini, supra*.

In the case of a transfer by gift, the amount of proceeds excluded from gross income is limited to the sum of: (a) the amount that would have been excludable by the transferor if no transfer had taken place; and (b) any premiums or other amounts subsequently paid by the transferee. Treas. Reg. § 1.101-1(b)(2), -1(b)(5), Ex. 6. However, if a transfer by gift is made by or to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer, all insurance proceeds are excluded from gross income. Treas. Reg. § 1.101-1(b)(2), -1(b)(5), Ex. 7. Thus, the gratuitous transfer of a life insurance policy from the insured to the insured's irrevocable grantor trust will not cause the trust to realize income upon the receipt of the insurance proceeds after the insured's death.

B. Proposed Regulations on the Transfer for Value Rules and Reportable Policy Sales

On March 25, 2019, the IRS issued proposed regulations on information reporting for certain life insurance transfers and modifications to the transfer for value rules. REG-103083-18. These proposed rules are relevant not only to life settlements but also to other transfers of life insurance policies, such as transfers to fund buy-sell agreements.

1. <u>Reportable Policy Sale</u>. Primarily, the proposed regulations deal with "reportable policy sales." The 2017 Tax Act[1] added IRC § 101(a)(3), which states that the exceptions to the transfer for value rule (*i.e.*, the related party exception and the carryover basis exception summarized above) will not apply if a transfer of a life insurance policy for valuable consideration is a reportable policy sale, defined as "the acquisition of an interest in a life insurance

[1] An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, Enacted December 22, 2017.

contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract." Prop. Reg. § 1.101-1(c)(1). In addition, as described briefly below, various reporting requirements apply when a life insurance policy is the subject of a reportable policy sale. IRC § 6050Y. Unlike many other provisions of the 2017 Tax Act, the provisions summarized above do not sunset after 2025.

An "indirect" acquisition of a life insurance policy includes "the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract." IRC § 101(a)(3)(B). "Other entity" in this definition does not include a C corporation unless more than 50% of the gross value of its assets consists of life insurance contracts. Prop. Reg. § 1.101-1(e)(3)(ii); *see also* Prop. Reg. § 1.101-1(c)(2)(iii); -1(g)(10), (12).

"An interest in a life insurance contract" is broadly defined as "the interest held by any person that has taken title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes, including any person that has taken title or possession as nominee for another person, and the interest held by any person that has an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other economic benefits of the policy as described in §20.2042-1(c)(2) of this chapter, such as the enforceable right to designate a contract beneficiary." Prop. Reg. § 1.101-1(e)(1).

The proposed regulations broadly define a substantial family, business or financial relationship for purposes of determining whether a transfer constitutes a reportable policy sale. Notably, a substantial family relationship would exist between an individual and his or her former spouse with regard to a transfer of an interest in a life insurance policy to (or in trust for the benefit of) that former spouse incident to divorce. Prop. Reg. § 1.101-1(d)(1). In addition, the definition of substantial business relationship would exclude from the definition of reportable policy sales the acquisition in the ordinary course of business of an entity that holds life insurance policies on its employees. Prop. Reg. § 1.101-1(d)(2), (4); -1(g)(11); *See* Gorin, Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications, Part II.Q.4.b.ii. (2nd Quarter, 2019).

2. Modifications to Transfer for Value Rule Exceptions. Prop. Reg. § 1.101-1(b)(1)(ii)(A) would modify the carryover basis exception to the transfer for value rule in IRC § 101(a)(2)(A) and Treas. Reg. § 1.101-1(b)(1) summarized above. This provision would prescribe that the limitation in IRC § 101(a)(2) (*i.e.*, limiting the exclusion from gross income to the amount of consideration paid and the premiums and other amounts subsequently paid by the transferee) would not apply to the transfer of a life insurance policy for valuable consideration if: (a) the transfer is not a reportable policy sale; (b) the basis of the interest transferred for the purpose of determining gain or loss with respect to the transferee is determinable in whole or in part by reference to the basis of that interest in the hands of the transferor; and (c) the following rule, Prop. Reg. § 1.101-1(b)(1)(ii)(B), does not apply to the transfer. However, the amount of proceeds from a policy transferred for valuable consideration, even if it does meet the requirements of this Prop. Reg. § 1.101-1(b)(1)(ii)(A), would be limited to the sum of: (a) the amount that would have been excludable by the transferor and (b) the premiums and other amounts subsequently paid by the transferee. In the case of a transfer of a life insurance policy from the original policyholder, this limitation on the amount excludable would have no effect because, if the life insurance policy had remained with the transferor, all of the death proceeds would have been excludable from gross income. *See* Gorin, *supra*.

Prop. Reg. § 1.101-1(b)(1)(ii)(B) would modify the related party exception to the transfer for value rule in IRC § 101(a)(2)(B) and Treas. Reg. § 1.101-1(b)(1) summarized above. This provision would prescribe that the limitation in IRC § 101(a)(2) (*i.e.*, limiting the exclusion from gross income to the amount of consideration paid and the premiums and other amounts subsequently paid by the transferee) would not apply to the transfer of a life insurance policy for valuable consideration if: (a) the transfer is not a reportable policy sale and the interest was not previously transferred for valuable consideration in a reportable policy sale and (b) the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer.

3. <u>Gratuitous Transfers</u>. The proposed regulations also address the taxation of proceeds from life insurance policies that were transferred by gift (including gratuitous transfers that are reportable policy sales). The amount of the proceeds attributable to the interest that is excludable from gross income under IRC § 101(a)(1) would be limited to the sum of: (a) the amount of the proceeds attributable to the gratuitously-transferred interest that would have been excludable by the transferor if the transfer had not occurred and (b) the premiums and other amounts subsequently paid by the transferee. Prop. Reg. § 1.101-1(b)(2)(i). The preamble to the proposed regulations explains that, although Treas. Reg. § 1.101-1(b)(2), discussed above, provides a special rule for gratuitous transfers made by or to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer, such a rule is not required by IRC § 101(a), and the proposed regulations do not contain a special rule for these transfers because it could be subject to abuse.

4. <u>Cleansing a Tainted Policy</u>. The examples in the proposed regulations show that, for sales that are <u>not</u> reportable policy sales, if the initial sale was a transfer for value, a sale back to the insured will cause the death proceeds to avoid the transfer for value rule. However, a gift back to the insured in this situation would not remove the death proceeds from the transfer for value rule. For sales that <u>are</u> reportable policy sales, no transfer back to the insured will remove the death proceeds from the transfer for value rule. *See* Gorin, *supra*.

5. <u>Reporting Requirements for Reportable Policy Sales</u>. When a sale of a life insurance policy constitutes a reportable policy sale, the proposed regulations would also provide rules concerning the reporting requirements under IRC § 6050Y. The reporting requirements are imposed on the acquirer of the life insurance policy. The acquirer must provide written statements to those who receive payments under a reportable policy sale and to the issuer of the life insurance policy. Prop. Reg. § 1.6050Y-2(a). The payment recipients will then use the written statement to determine the amount of the payment received that constitutes taxable income. *See* Leimberg, LISI Income Tax Planning Newsletter #178 (March 25, 2019) at http://www.leimbergservices.com. The acquirer must furnish the written statement to the payment recipient on or before February 15 of the year following the year in which the reportable policy sale occurred. Prop. Reg. § 1.6050Y-2(d)(1)(ii).

The acquirer need not provide a written statement to an issuer in an indirect acquisition. Prop. Reg. § 1.6050Y-2(d)(2)(i)(B). Exceptions would apply to acquirers that are foreign persons. Prop. Reg. § 1.6050Y-2(f).

6. Applicability. The proposed regulations would apply to reportable policy sales made after December 31, 2017. For any other purpose, the proposed regulations apply to transfers of life insurance policies, or interests in policies, made after the date that the proposed regulations are finalized and published in the Federal Register.

7. Employer-Owned Life Insurance Contracts. The proposed regulations would update Treas. Reg. § 1.101-1(a)(1) to reflect the enactment of IRC § 101(j) in 2006 by simply stating that the amount excluded from gross income under IRC § 101(a) may be affected by IRC § 101(j). Prop. Reg. § 1.101-1(b)(1)(i).

IRC § 101(j) is the primary provision dealing with the taxation of employer-owned life insurance ("EOLI") contracts. In general, this subsection provides that death proceeds paid under an EOLI contract are included in gross income to the extent such proceeds exceed the premiums and other amounts paid by the applicable policyholder, unless certain exceptions are met. IRC § 101(j)(1). Any proceeds in excess of those two amounts will be subject to tax at ordinary income rates. Leimberg, LISI Estate Planning Newsletter #1467 (May 22, 2009) at http://www.leimbergservices.com (hereinafter, Leimberg #1467).

An "employer owned life insurance contract" is defined as a life insurance contract which: (a) is owned by a person engaged in a trade or business (irrespective of the type or size of the business) and under which such person or a related person is directly or indirectly a beneficiary under the contract; and (b) covers the life of the insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued. IRC § 101(j)(3)(A). A life insurance contract that is owned by a sole proprietor on his or her own life is not an EOLI contract. Leimberg #1467, *supra*. The term "applicable policyholder" essentially means the owner of the EOLI contract (as referenced in the first part of the definition of an EOLI contract) or a related person. IRC § 101(j)(3)(B).

a. Exceptions to Taxation of Proceeds. The statute provides for two exceptions to the general rule, meaning that, if the EOLI contract meets the requirements for one of these exceptions, then the entire amount of the death proceeds will be excluded from the policyholder's gross income under the general rule of IRC § 101(a)(1).

Any amount received by reason of the death of an insured who, with respect to an applicable policyholder: (1) was an employee at any time during the 12-month period before the insured's death; or (2) is, at the time the contract is issued, a director, a highly compensated employee (as defined in IRC § 414(q)) or individual (as defined in IRC § 105(h)(5), except that the individual must be among the top 35%, rather than the top 25%, of the highest paid employees), is not included in the policyholder's gross income. IRC § 101(j)(2)(A).

In addition, any amount received by reason of the death of the insured will not be includible in the policyholder's gross income to the extent that: (1) the amount is paid to a member of the family of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary or the estate of the insured; or (2) the amount has been used to purchase an equity interest in the applicable policyholder from any person described in option (1). IRC § 101(j)(2)(B). The purchase of the equity interest must be paid by the due date, including extension, of the tax return for the taxable year of the applicable policyholder in which death benefit is received. Notice 2009-48, 2009-24 I.R.B. 1085, A-6.

To qualify for either of these exceptions, however, the notice and consent requirements of IRC § 101(j)(4) must be met. Before the issuance of the EOLI contract, the employee must be notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued. In addition, the employee must provide written consent to being insured under the contract and that such coverage may continue after the insured terminates employment. Finally, the employee must be informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

For purposes of IRC § 101(j)(2)(A) and (j)(4), an EOLI contract is treated as "issued" on the later of: (1) the date of application for coverage, (2) the effective date of coverage or (3) the formal issuance of the contract. The IRS has stated that an inadvertent failure to satisfy the notice and consent requirements may not prohibit the application of one of the exceptions under IRC § 101(j)(2). Notice 2009-48, 2009-24 I.R.B. 1085, A-4, A-13.

b. <u>Definition of Employee</u>. Another important limitation to the application of IRC § 101(j) is the definition of an employee, which only includes an officer, director and a highly compensated employee (within the meaning of IRC § 414(q)). IRC § 101(j)(5)(A). Under IRC § 414(q), a former employee is treated as a highly compensated employee if the individual was a highly compensated employee when he or she separated from service or was a highly compensated employee at any time after attaining age 55. Leimberg #1467, *supra.*

c. <u>Annual Filing Requirements</u>. Every applicable policyholder that owns one or more EOLI contracts issued after August 17, 2006 must file Form 8925 setting forth specific information for each year the contracts are owned. IRC § 6039I; Leimberg #1467, *supra*.

C. Life Settlements and Basis After the 2017 Tax Act

For purposes of life settlements of life insurance policies, the 2017 Tax Act provides that a seller's basis in a life insurance policy is not reduced by the cost of insurance (*e.g.*, premiums paid). IRC § 1016(a)(1)(B). This provision reverses the IRS's position, stated in Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, that the seller's basis is reduced by the premiums paid. This provision is effective retroactively to transactions entered into after August 25, 2009 and does not sunset after 2025.

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