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Income Taxation of Life Insurance

The following information provides a general overview of the income taxation of U.S. life insurance policies as well as addresses some of the most frequently asked questions that we receive on the topic. U.S. residency and citizenship are assumed throughout this guide.

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1. How is life insurance defined under the Internal Revenue Code (IRC)?

As part of major legislation enacted in the 1980's – mostly notably the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Deficit Reduction Act of 1984 (DEFRA) – Internal Revenue Code §7702 was created.

To qualify as life insurance under §7702, a contract must meet either the "cash value accumulation test" or the two-pronged "guideline premium and corridor test" as follows:

- The *cash value accumulation test* (CVAT) often applies to traditional permanent life insurance policies accumulating cash value and generally limits the cash value within a policy to the "net single premium" required to fund all future benefits provided under the contract.[1] The net single premium is calculated by using an assumed interest rate, mortality charges specified in the contract, and other specified charges. A CVAT contract must satisfy the test at all times and must do so by the terms of the contract.
- The *guideline premium and corridor test* (GPT) often applies to policies where accumulating cash or maintaining a variable death benefit is most important. The test is a combination of two tests—the "guideline premium" requirement and the "cash value corridor" requirement. The guideline premium requirement restricts the total premium that can be paid into the policy to a one-time premium that would fund the future benefits of the policy (taking into account an assumed interest rate and mortality charges). The cash value corridor requirement is satisfied if at all times the policy's death benefit exceeds a stated multiple of the contract's cash value.

These tests were created to ensure that sufficient mortality risk is maintained and prevent policies from being used merely for their tax-deferred cash accumulation feature. A contract that fails to meet the testing requirements of §7702 will not be considered "life insurance" and will not receive the same tax advantages that life insurance receives. (See Question 15 for information on the taxation of a policy that fails §7702 testing requirements).

In 1988 as part of the Technical and Miscellaneous Revenue Act (TAMRA) Congress enacted additional testing requirements on life insurance to once again deter the use of life insurance solely as a tax deferred cash accumulation vehicle. This new test – referred to as the "7-Pay Test" – limits the cumulative amount of premiums that can be paid into a contract in the first seven years.[2]

More specifically, a life insurance contract will fail to meet this test if:

The cumulative premiums paid into the contract during the first 7 years	>	The sum of the net level premiums that would have been paid if the contract provided for paid-up future benefits after the payment of 7 level annual premiums

Policies that fail to meet the 7-Pay Test, but otherwise meet TEFRA and DEFRA testing requirements, are considered to be Modified Endowment Contracts (MECs) and are subject to special taxation rules. The tax treatment of MECs is discussed in more detail in Question 14.

2. Is the death benefit payable upon the death of the insured subject to income taxation?

IRC §101(a)(1) provides that gross income generally does not include amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured. In other words, life insurance death benefits are usually not taxable income to the beneficiary or beneficiaries of a life insurance policy. This tax-free treatment of death benefit applies to both traditional life insurance contracts and to modified endowment contracts (MECs).

Two notable exceptions exist with respect to this general rule regarding the tax-free treatment of insurance proceeds:

1. proceeds received when there has been a "transfer-for-value" as specified in §101(a)(2); and
2. proceeds received on an employer-owned contract that does not meet the requirements under §101(j)

For more information on these exceptions, please see Questions 16 and 19, respectively.

Furthermore, keep in mind that once the proceeds become payable, any interest or investment income earned on the proceeds under a settlement agreement is also taxable. For example, if a beneficiary elects to receive insurance proceeds payable in a series of installments, instead of as a lump sum, the principal portion will be tax-free, but any interest accrued will be taxable as ordinary income.

3. Are cash value increases taxable to the owner?

If a contract meets the definition of life insurance under §7702, annual increases in cash surrender value will not be subject to income taxes while the policy is in force. For as long as a policy remains in force, cash value buildup within a policy will experience indefinite tax deferral and if the policy terminates at death, any gains will generally be exempt from taxation.

See Question 23 for special rules pertaining to the taxation of life insurance owned by a C corporation.

Although the deferral of taxation on cash value growth is not specifically provided for in the tax code, this treatment is consistent with the tax treatment of other assets that are held by a taxpayer and not disposed of in any given year. For example, a taxpayer is not taxed on the appreciation of stock values year to year unless that stock is sold or otherwise disposed of.

This principle is further supported by reference to the tax treatment of life insurance policies that do not meet the statutory definition of life insurance under §7702. Under §7702(g), income on a life insurance contract that *does not* meet the definition of life insurance under §7702(a) will be treated "as ordinary income received or accrued by the policyholder during such year." The fact that the Code specifically states that life insurance contracts that do not meet the §7702 definition are taxed year-to-year on the income strongly suggests that generally a life insurance policy that does meet the §7702 requirements will receive tax-deferred growth of the cash value inside the contract.

See Question 15 for information on the taxation of a life insurance policy that does not meet the statutory requirements of §7702.

4. When are withdrawals subject to income tax?

Under the cost recovery rule of IRC §72(e), amounts received from a life insurance contract that is not classified as a MEC are first considered to be a non-taxable recovery of the owner's "investment in the contract" and only amounts received in excess over the investment in the contract are considered taxable. In layman's terms, §72(e) generally provides that life insurance is taxed on a "first in, first out" (FIFO) method, meaning that the policy owner will receive his or her investment in the contract first before receiving any gains in the policy (or being taxed on those gains).

There is an exception to the general rule that withdrawals up to investment in the contract are generally received tax-free. This exception applies to withdrawals within the first 15 years of issuance of the policy if there is also a reduction in the policy's death benefit. For policy withdrawals in such a case, income growth may be treated as coming out before investment in the contract, up to a statutory "recapture ceiling." (See Question 5.)

For life insurance contracts classified as MECs, special taxation rules apply with respect to accessing cash value during the insured's lifetime. For more information on the tax treatment of MECs, see Question 14.

PLANNING NOTE

Before taking withdrawals or reducing death benefit, it is prudent to have an in force illustration run to determine if such actions could cause an income tax event or cause the policy to fail the 7-Pay Test and cause the policy to become a MEC.

5. How is the recapture ceiling for withdrawals and surrenders calculated?

The recapture ceiling varies depending on the year of the withdrawal/surrender within the applicable 15 year period.

POLICY TESTING METHOD (SEE QUESTION 1)	RECAPTURE CEILING FOR YEARS 1-5	RECAPTURE CEILING FOR YEARS 6-15[3]
CASH VALUE ACCUMULATION TEST (CVAT)	Excess of (i) the cash surrender value of the contract immediately before reduction in benefits over (ii) the net single premium immediately after the reduction[4]	Excess of (i) the cash surrender value immediately before reduction in benefits over (ii) the maximum cash value permitted under the cash value corridor immediately after the reduction
GUIDELINE PREMIUM AND CORRIDOR TEST (GPT)	Greater of:[5] **1.** Excess of (i) the aggregate premiums paid prior to the reduction in benefits over (ii) the adjusted guideline premium limitation for the contract; **2.** Excess of (i) the cash surrender value immediately before reduction in benefits over (ii) the maximum cash value permitted under the cash value corridor immediately after the reduction	Excess of (i) the cash surrender value immediately before reduction in benefits over (ii) the maximum cash value permitted under the cash value corridor immediately after the reduction

EXAMPLE[6]

In Year 1, A purchases a life insurance policy contract with $350,000 death benefit. The contract meets the definition of life insurance tested under the CVAT prescribed in §7702. The contract is not a MEC. A pays a total of $45,000 in premiums in Years 1-4 and at the end of Year 4 the policy's cash surrender value is $60,000.

A surrenders 60% of the contract and receives a $36,000 distribution from the contract. The death benefit also decreases to $140,000 as a result of the partial surrender. Based on A's age at the time of the surrender, the net single premium was $355 per $1000 of insurance coverage.

What amount of the $36,000 distribution, if any, is taxable to A?

Immediately prior to the surrender, the income built up inside the contract was $15,000 – [$60,000 CSV - $45,000 Basis = $15,000]

The partial surrender done at the end of Year 4 reduced the death benefit from $350,000 to $140,000. Because a reduction in benefits occurred in the first 5 years of the contract and the contract qualified under the CVAT approach, the recapture ceiling is the excess of:

(i) the contract's $60,000 CSV immediately before the reduction in benefits, OVER

(ii) the net single premium immediately after the reduction in benefits.

The net single premium for the contract's reduced death benefit was $49,700 – [$140,000 reduced death benefit x $355/$1000 net single premium = $49,700]

Consequently, the recapture ceiling is $60,000 - $49,700 = $10,300

Based on this recapture amount, of the $36,000 received by A, A must include all $10,300 into gross income. The remaining $25,700 of the distribution is treated as a return of a portion of A's $45,000 basis in the contract. A's basis in the contract immediately after the surrender is $19,300 – [$45,000 - $25,700 = $19,300].

6. How is the "investment in the contract" calculated? What is the difference between "investment in the contract" and "basis?"

Taxation of amounts received under a life insurance contract, e.g., surrenders, withdrawals, dividends, etc., are all governed by §72 and the owner's "investment in the contract."

A policy owner's "investment in the contract" is defined in §72(e)(6) and is equal to:

1. the aggregate amount of premiums or other consideration paid for the contract, ***minus***
2. the aggregate amount received under the contract to the extent such amount was excludible from income

Some examples of "amounts received" that would reduce the investment in the contract include: withdrawals, dividends received, surrendered PUAs, and rider charges.

In comparison, "basis" (aka "cost basis") applies to situations when gain or loss is determined under code sections *other than §72.* For example, if a policy is sold rather than surrendered, the policy owner's "adjusted basis" should control the tax treatment per §1001.

Basis generally equals the cost of the property as provided in §1012, adjusted for various factors. In gifting situations, basis generally is determined in accordance with §1015.

PLANNING NOTE

In most cases, "basis" and "investment in the contact" will be equal to each other; as such, these terms are often used interchangeably by industry professionals. However, there are instances where basis (or "adjusted basis") and investment in the contract could differ, so it is important to identify the tax transaction that is occurring to ensure proper taxation. See Question 8 for an example of where investment in the contract and basis leads to different tax results.

7. What are the tax implications of withdrawing cash value or paying off a policy loan immediately before or after a §1035 exchange?

IRC §1035 provides for the tax-deferred exchange of life insurance and annuities. Under a qualified "1035 exchange," a policy owner may exchange an existing life insurance policy for a new life insurance policy and defer any gain. Assuming the exchange falls under the purview of §1035, the newly acquired insurance policy will have the same basis and investment in the contract as the policy given up in the exchange.[7]

As discussed throughout this BYA, under §72, the owner of a life insurance contract can generally withdraw policy cash values up to the owner's investment in the contract without recognizing gain. However, §1035 exchanges are permissible under, and controlled by, §1031, not §72.[8] Under §1031(b), if an owner exchanges like-kind property but also receives "other property or money" in addition to the like-kind property, this additional property generally will be considered "boot."

Funds received by withdrawing cash value or paying off a loan using policy cash value during a 1035 exchange, or in close proximity before or after the exchange, generally will be considered "boot," which means that the policy owner will recognize income on the boot received to the extent of gain in the insurance contact.

For more information, please refer to our **BYA on 1035 exchanges.**

8. What are the income tax consequences of policy surrender resulting in a gain? Does the same hold true for policies that are sold versus surrendered?

When a life insurance policy or endowment contract is surrendered for its cash surrender value, the Code provides that any gain on the policy will be subject to ordinary income taxation to the extent the cash surrender value plus any policy loans outstanding at the time of surrender exceed the owner's *investment in the contract.*[9]

EXAMPLE

In year 1, Andrew purchases a permanent life insurance policy on his own life. In policy year 8, Andrew surrenders the policy for its cash surrender value of $78,000. Up until the time of surrender, Andrew paid premiums totaling $64,000 and has never taken a distribution or a loan from the policy. Under §72(e)(5), gain is determined by subtracting Andrew's investment in the contract (i.e., $64,000) from the amount received ($78,000- CSV). Andrew must recognize $14,000 of income on surrender of the contract.[10]

Prior to the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA), the IRS had previously ruled in Revenue Ruling 2009-13 that in determining the amount of gain incurred in the **sale** (as opposed to a surrender) of a life insurance contract, the taxpayer's basis in the policy should be reduced by the "cost of insurance" charges incurred. With the enactment of the TCJA, Revenue Ruling 2009-13 was reversed and adjustments to basis for COI charges are no longer necessary. Consequently, the amount of gain from the sale of a life policy generally will be equal to the excess of the amount realized (i.e., value received in the sale) over the owner's adjusted basis in the policy, with no adjustment for COIs.

The gain resulting from a sale of a life insurance policy may have parts that must be treated as ordinary income and parts that must be treated as capital gain. According to the "substitute for ordinary gain" doctrine, the amount that would have been recognized as ordinary income in surrender should be recognized as ordinary gain in a sale. Any consideration in excess of this amount should constitute capital gain. In other words, capital gain treatment is recognized on the sale of a life insurance policy where the consideration exceeds the cash surrender value of the policy.

9. What are the income tax consequences of policy surrender resulting in a loss?

The general rule is that losses recognized upon surrender or sale of a policy are not deductible to the policy owner. However, in some cases, a taxpayer may be able to deduct a loss if the loss was incurred in a trade or business or in a for-profit transaction (IRC §165(c)).

10. Are policy loans taxable?

Loans taken out against a life insurance policy are generally not taxable (but see the discussion below if the policy is a MEC). As long as the policy remains in force, the loan will not be taxed (except that transferring a policy with loans in excess of basis usually triggers taxable income and is considered a transfer for value). Loans outstanding on a policy at the death of the insured will reduce the death benefit by the loan amount, but will not cause an income tax recognition event as death benefit is generally received income tax free under §101(a).

If a policy is surrendered with an outstanding loan, the loan reduces the surrender amount payable to the policy owner, but will not reduce the tax liability recognized by the taxpayer.

For example, if Ed owns a policy on his own life with a gross cash surrender value (CSV) of $100,000, an investment in the contract of $50,000 and an outstanding Loan amount of $75,000, upon surrender Ed will recognize $50,000 of ordinary income ($100,000 CSV – $50,000 Investment in the Contract) even though he only receives $25,000 ($100,000 CSV - $75,000 Loan) from the policy itself at the time of surrender.

These same rules apply to a contract that lapses with an outstanding loan.

Note that an important exception applies to MEC policies. Loans from MEC policies are taxable as income at the time the money is borrowed to the extent that cash value exceeds basis in the contract. An additional ten percent penalty may also apply to loans from a MEC. See Question 14 for more information on MECs.

11. Is the interest on a policy loan deductible?

Whether the interest on a policy loan is deductible depends on how the interest is classified for income tax purposes. Interest is typically classified in one of three manners: (a) trade or business interest; (b) investment or passive activity interest; or (c) personal interest.

A. *Trade or Business Interest*[11] – For contracts purchased after June 20, 1986, the deductibility of trade or business interest is significantly limited. Until 1996 legislation was passed, there was a general rule of non-deductibility for loan interest on company owned policies. For contracts issued after 1996, there is an exception to the general rule for policy loan interest paid on policies insuring a key person up to $50,000. Note, however, that interest in excess of the applicable federal rate cannot be deducted.

Legislation passed in 1997 further limited the deductibility of policy loan interest by adding a provision that generally provides that no deduction is permitted for the part of the taxpayer's interest expense that is "allocable to unborrowed policy cash values." Unborrowed policy cash value is the excess of the cash surrender value over the amount of the loan. There is an exception to this rule that applies to entity-owned policies that cover only one individual, who at the time first covered by the entity, is (1) a 20 percent owner of the entity or (2) an officer, director or employee of the trade or business.

B. *Investment/Passive Activity Interest* – If the loan proceeds were used to purchase an investment or for a passive activity, it is likely that the interest may be treated as investment interest or passive activity interest and will be deductible subject to investment interest limitations.

C. *Personal Interest* – Interest on a policy loan that is neither trade/business nor investment income (i.e. "personal") is not deductible under any circumstance.

Note, however, that even if a deduction is otherwise allowable, interest paid to purchase a single premium insurance contract will not be deductible.[12] Additionally, if premium payments are financed through policy loans, no deduction is allowable, unless certain exceptions are met.

12. Are dividends received from a life policy taxable?

Dividends received from a life insurance policy are treated as a distribution from the contract and taxed similarly to other types of distributions.[13] Accordingly, dividends are distributed income-tax free to the extent of the owner's investment in the contract – that is, dividends received reduce the owner's investment in the contract and only become taxable when the taxpayer's investment in the contract has been reduced to zero. Dividends are considered "received" regardless of whether they are paid in cash, used to purchase paid-up additions (PUAs), used to purchase one year term insurance or left to accumulate with interest.

When dividends are used to purchase paid-up additions, the owner's investment in the contract will be reduced by the dividend amount, but also will receive an increase in the same amount to account for the premium payment in the PUAs – effectively leaving the taxpayer in a neutral position relative to the taxpayer's investment in the contract.

Note that any interest on dividends held in an accumulated dividends account is also taxable to the owner in the year they are credited to his/her account, regardless of whether or not the interest is actually withdrawn.[14]

If the policy is a MEC, cash dividends paid to the owner will be considered income to the owner to the extent of any gain in the policy. These dividends may also be subject to a 10% penalty unless the owner is over age 59 ½ or is disabled. However, dividends used to pay premiums or purchase additional insurance are not taxable to the owner of a MEC contract.[15]

13. What are the income tax consequences of paid-up additions versus accruing dividends in a whole life policy?

Dividends used to purchase additional life insurance coverage are known as "paid-up additions." They allow the owner of a policy to purchase additional coverage without the need for additional premiums or medical underwriting. For income tax purposes, paid-up additions are treated in the same manner as the underlying base policy and will enjoy tax-deferred growth.

Alternatively, if dividends are left to accrue, and are not used to purchase additional insurance, the growth in the dividends is taxed as interest income. Because interest earned on accrued dividends will be taxable as ordinary income, electing to use dividends to purchase paid-up additions is often a more attractive option than accumulating dividends at interest.

14. How are Modified Endowment Contracts (MECs) taxed?

Policies entered into on or after June 21, 1988 that fail the 7-Pay Test (see Question 1), but otherwise meet the testing requirements for life insurance, are classified as modified endowment contracts ("MECs").[16] Single premium contracts are most often the culprit for MEC classification, although short-pay scenarios and/or a reduction in benefits on a non-MEC policy can create a MEC.

MECs generally enjoy the same income-tax free treatment of death benefit proceeds that non-MEC life insurance policies receive. Similar to non-MEC policies, cash value build-up within MEC policies also experiences tax-deferred growth. However, there is a notable difference between MEC and non-MEC policies regarding withdrawals from cash buildup within a policy. In MEC policies, withdrawals are taxed on a last-in, first-out basis (LIFO), which results in gain being withdrawn first and being immediately taxed as ordinary income. In comparison, withdrawals from a non-MEC policy are taxed on a FIFO basis, meaning that withdrawals are taxable as ordinary income only to the extent they exceed the owner's investment in the contract.

Distributions for the purposes of this rule include loans, pledging or assigning the MEC as collateral, dividends received, withdrawals and surrenders. Moreover, distributions taken prior to the taxpayer turning 59 ½ or becoming disabled may be subject to a 10% penalty tax.[17]

Grandfathered policies (i.e. contracts issued prior to June 21, 1988) are not subject to these MEC rules unless the contract fails the 7-Pay Test after a "material change" has occurred. A "material change" includes, but is not limited to, any increase in death benefit or qualified additional benefits (QABs) under the contract, except for:

- Increases that are attributable to the payment of premiums necessary to fund the lowest level of death benefit and QABs payable in the first 7 years of the contract, or
- Cost of living death benefit increases that are based on a broad-based index if such increase is funded ratably over the remaining period during which premiums are required to be paid.[18]

15. What is the taxation of a life insurance policy that does not meet the statutory requirements of IRC §7702?

If a life insurance contract fails the testing requirements under IRC §7702, the accrual of cash value within the contract will be taxable to the policyholder each year. If a contract is compliant under §7702 but later becomes non-compliant, the accrual of income for all prior taxable years will be treated as being received or accrued during the taxable year of non-compliance.

The death benefit associated with a non-compliant policy generally will be received by the beneficiary income-tax free to the extent that the death benefit exceeds the net surrender value of the contract.

16. What is the Transfer-for-Value Rule?

IRC §101(a)(2) provides that in situations where the life insurance contract or death benefit has been transferred for cash or valuable consideration, a portion of the death benefit becomes subject to income taxes. The amount of the death benefit that will be taxable income is the excess of the death benefit over the amount actually paid for the contract plus any premiums and other amounts paid by the transferee following the transfer.

Fortunately, there are exceptions to the transfer-for-value rule that are delineated in IRC §101(a)(2)(A) and (B) that can prevent the death benefit from being subject to income taxes after a transfer for value has occurred. Notably, if the transfer is made to any of the following, the death benefit is received income tax free:

- The insured individual
- A partner of the insured
- A partnership in which the insured is a partner
- A corporation in which the insured is a shareholder or officer

Transfers of a policy whereby the transferee takes the transferor's basis (in whole or in part) in the policy are also exempt from the transfer for value rules. Examples of basis transfer includes: gift of policies, transfers between spouses, and transfers subject to a tax-free corporate reorganization.

Under the 2017 Tax Cuts and Jobs, a transfer-for-value issue may arise if there is a "reportable policy sale." A "reportable policy sale" is defined generally as the acquisition of an interest in a life insurance 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 the life insurance contract). The law provides that the exceptions to the transfer for value rules under IRC §101(a)(2)(A) do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income. The new basis rule is effective for contracts issued after August 25, 2009; otherwise these provisions are effective for reportable sales entered into, and reportable death benefit received, after December 31, 2017.

For more in-depth coverage of this topic, please see our **BYA on Transfer for Value**.

17. Are premiums paid on personal life insurance deductible?

Life insurance is considered a personal expense and premiums paid for coverage are typically not deductible under IRC §264. Exceptions may include premiums paid by an individual on behalf of a policy owned by a charity.[19] Furthermore, insurance premiums paid for by an employer in the employee benefit context may also be deductible (see Question 21).

18. What is the taxation of charges against cash value for a Long-Term Care (LTC) Rider?

For tax years *after* December 31, 2009 (effective date of the Pension Protection Act of 2006), the LTC rider charge against the cash value of an insurance policy is not included in income, but will reduce the investment in the contract (but not below zero).[20] This rule applies whether the life insurance contract is classified as a modified endowment contract (MEC) or not.

For tax years beginning *before* January 1, 2010, LTC charges were treated as partial withdrawals. If the policy was a MEC, those withdrawals were taxable income to the extent that there was gain in the policy. The 10% penalty may also have been applicable to those withdrawals. If the policy was a MEC but there was no gain in the contract, the withdrawals reduced the owner's investment in the contract, same as with non-MEC policies.

19. What is the tax treatment of the death benefit for employer-owned contracts under §101(j)?

IRC §101(j) provides that the death benefit received on an employer-owned life insurance contract will not receive tax-free treatment unless certain requirements are met. To meet these §101(j) requirements, prior to the policy being issued, the employer must provide the insured-employee with notice that the employer is obtaining life insurance on the employee's life (and the amount for which the employee may be insured) and obtain consent from the employee agreeing to this purchase.

Additionally, ***one*** of the following scenarios must also be met to keep the policy proceeds income-tax free:

- Insured-employee was an employee at any time during the 12 month period preceding the employee's death;
- Insured-employee was a director or highly compensated individual at the time the policy was issued;
- Death benefit is paid to a member of the insured's immediate family, to an insured's designated beneficiary, to the insured's estate or to a trust for the benefit of the insured's family; or
- Death benefit is used to purchase an equity interest in the business from the insured's family or trust.

For more information, please see our **BYA on Employer-Owned Life Insurance (EOLI)**.

20. How is group term insurance taxed to an employee?

Under an employer-provided group term life insurance plan, the premium cost for the first $50,000 in coverage does not have to be reported as income and will not be taxable. Amounts in excess of $50,000 will be considered "imputed income" and will trigger taxable income to the employee in the amount of the "economic value" of the coverage. Taxable amounts are subject to ordinary income tax rates.

21. Are premiums paid by an employer for life insurance tax deductible by the employer?

It depends. Premiums paid by an employer for group life insurance are usually deductible by the employer as a business expense. Premiums paid by an employer for a policy owned by the employee as part of a bonus plan (typically referred to as a 162 Bonus) also are generally deductible as a business expense.

Premiums paid by an employer on a policy owned by the employer – e.g., key man policy or policy purchased for buy-sell funding or funding a deferred compensation plan – are not deductible per §264.

22. What are the tax implications if an employer owns a policy on an employee's life but allows the employee to name a beneficiary for some or all of the death benefit?

When an employer owns a life insurance policy on an employee's life and allows the employee to name a beneficiary for all or a portion of the policy (e.g. his/her spouse, children, trust, etc.), the arrangement is governed by the Final Split Dollar Regulations ("Final Regulations").[21]

These Final Regulations call for the employee to recognize into income each year the "economic benefit" associated with the death benefit being provided to the employee's family. This economic benefit cost represents the term cost associated with the insurance death benefit. If the employee does not recognize this economic benefit cost into income, the Final Regulations provide that the death benefit paid to the employee's family is subject to income tax as if the employer had paid this amount out as compensation.[22]

For more information on split dollar arrangements, please see our **Split Dollar Client Guide**.

1. IRC §7702(b)(1).
2. See IRC §7702A.
3. IRC §7702(f)(7)(D).
4. IRC §7702(f)(7)(C)(i).
5. IRC §7702(f)(7)(C)(ii).
6. Rev. Rul. 2003-95.
7. See Rev. Rul. 2002-75.
8. Priv. Ltr. Rul. 8905004.
9. See IRC sec 72(e)(A) and Blum v. Higgins, 150 F.2d 471 (2nd Cir. 1945).
10. See Rev. Rul. 2009-13, Situation 1.
11. IRS Publication 525 (2015).
12. IRC §264(a)(2).
13. IRC §72(e)(1)(B).
14. *Theodore H. Cohen v. Comm'r.*, 39 T.C. 1055 (1963).
15. IRC §72(e)(4)(B).
16. IRC §7702A.
17. IRC §72(v).
18. IRC §7702A(c)(3)(B).
19. See, §170(a).
20. Section §72(e)(11).
21. See Treas. Reg. §1.61-22.
22. Treas. Reg. §1.61-22(e)(3).