

Watch Your Step When Combining Life Insurance and Corporations

One of the many positive aspects of life insurance is that proceeds are usually distributed tax free. But this can change when corporations are thrown into the mix. Several corporation-related situations can result in substantial tax liability. Consider the following tips to avoid paying more tax than you have to.

Tip 1: Dodge the AMT

When the beneficiary is a C corporation, as is often the case when a buy-sell agreement calls for a stock redemption on the death of a shareholder, proceeds from insurance policies owned by and payable to the corporation may affect the corporate alternative minimum tax (AMT) calculation, to the extent that those proceeds exceed the corporation's basis in the insurance policy.

The Taxpayer Relief Act of 1997 made this scenario a little easier to avoid by repealing AMT for small corporations. The act defines small corporations as those that had average

gross receipts of \$5 million or less for the three years ending Dec. 31, 1997.

Tip 2: Watch Out for The Transfer-for-Value Rule

If a redemption agreement has caused an AMT problem, you may consider switching to a cross-purchase agreement by having the shareholders buy the policies from the corporation. Although this may solve the AMT problem, it may trigger the transfer-for-value rule: If a policy owner transfers a policy to the beneficiary in exchange for valuable consideration, the death benefit is tax-free only to the extent of the beneficiary's basis in the policy. Any proceeds the beneficiary receives in excess of basis are taxable to the beneficiary as ordinary income.

The transfer-for-value rule does not apply in certain situations, such as when a policy owner transfers the insurance to the insured, a partner of the insured, a partnership in which the insured is a partner, a corporation in which the insured is a shareholder or an

officer. Thus, if the shareholders are also partners in an ancillary partnership, the partnership can buy the policies without triggering the transfer-for-value rule. You may contact us for additional exceptions.

The following is an example to help clarify the transfer-for-value rule: From her father, Anne purchases an insurance policy on his life for the cash surrender value of \$20,000 and pays the \$2,000 premium for the next five years. On her father's death, Anne receives insurance proceeds of \$200,000. Only the equivalent of her \$30,000 basis (acquisition cost plus premium payments) will be tax-free to Anne — \$170,000 will be taxable to her as ordinary income.

Tip 3: Remember Shareholder Proceeds Can Result in Tax Liability

If a corporation owns a policy insuring a shareholder's life and the proceeds are payable to someone other than the corporation, the incidents of ownership in the policy may be attributable to the insured and therefore, be includable in his or her gross estate. This rule will apply if the insured is a controlling shareholder (a shareholder who owns more than 50% of a corporation's voting stock at the time of his or her death).

Of course, considering the effect on the estate plan of any buy-sell or stock purchase agreements a shareholder may have in place is important. A shareholder who owns less than 50% of a corporation's stock today may later become a controlling shareholder as a result of the death of a parent, spouse or business partner. This will result in the shareholder acquiring incidents of ownership due to the attribution rules and thus, undesirable estate tax consequences.

Tip 4: Keep an Eye Out For Rising Stock Value

When the corporation owns a policy insuring the life of a controlling shareholder and the insurance proceeds are payable to or for the benefit of the corporation, the proceeds will not be includable in the shareholder's gross estate. However, the value of the stock in the shareholder's estate will, in all likelihood, increase when the corporation receives the proceeds.

Tip 5: Avoid Dividend Taxation

Generally, a corporate-owned policy on a noncontrolling shareholder's life will not result in income tax consequences for the insured. If the named beneficiary of the

policy is also a shareholder, both the insured (to the extent of premiums paid) and the beneficiary (to the extent of proceeds received) can be deemed to have received a benefit from the corporation that may be taxed as a dividend.

***Remember This Motto —
Be Prepared!***

If you are not cautious and aware, the life insurance you purchased to avoid taxes may end up costing more than you originally anticipated. To avoid any of the previously discussed scenarios, contact one of our trained professionals for assistance. We would welcome the opportunity to help you achieve your financial objectives.