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White paper

Is business life insurance tax deductible?

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Key highlights

- Case studies of commonly asked questions regarding the tax deduction eligibility of premiums
- Applicable code/treasury regulation sections
- Generally accepted accounting principles

Generally speaking, Congress gives us an income tax free life insurance death benefit. What about the premium, could it be deductible? It seems unlikely that Congress would give us the benefit both ways. Therefore, it is reasonable to assume that it will not give us an income tax deduction for the premium as well. By and large, that is correct.

Here are thirteen case studies relating to businesses and life insurance (all with valid reasons for the life insurance), along with citations to the applicable sections of the Internal Revenue Code and Treasury Regulations that govern the deductibility of the premiums. In addition to the case studies, the applicable provisions are paraphrased. There are also comments emphasizing the importance of documenting arrangements, and comments about generally accepted accounting principles as they relate to life insurance expense, income and financial statement presentation.

Case studies

1. **Business owned life insurance policy with the business as the beneficiary on life of business owner**
   "I want my business to buy life insurance on my life. The business will be the owner and beneficiary. It's for key person indemnification, to provide the business with a cushion of capital if I should die. Is the premium deductible?"

   That is a clearly valid need but the premium is not deductible. *Section 264(a)(1)*

2. **Business owned life insurance policy with a personal beneficiary**
   "I want my business to buy life insurance on my life. The business will be the owner of the policy[1] but my spouse will be the beneficiary. I need it because my spouse will suffer financially if I were to die. Is the premium deductible?"

   The premium is not deductible. *Section 264(a)(1).*

- **Further,** if your business is a corporation, the premium should be included in your gross income and will be income taxed; but there will not necessarily be an automatic, offsetting business deduction for compensation.[2] Section 61, and Treas Reg Section 1.61-2(d)(2)(ii). You could be double taxed on the premium, first by including it in your gross income and second by not allowing the offsetting compensation deduction. That would hold true whether your business is taxed as a C corporation or as a pass through entity (e.g. S corporation, partnership, or sole proprietorship).

  In addition, in the absence of a formal, written split dollar arrangement, should you pass away the IRS could attempt to tax the death benefit to your surviving spouse as ordinary income. Section 61(a) IRC taxes all income unless specifically exempted, so in the absence of business documentation proving it is a life insurance death benefit it would be subject to income tax.

  Solution. The solution is to own the policy yourself. The business can pay the premium, treating it as additional compensation[3] or a capital distribution. That way you will avoid possible income tax on the death benefit.[4]

3. **Using a business check to pay for a business owner's personal life insurance policy**
   "I need personal life insurance. I will own the policy and my spouse will be the beneficiary. I want to write a company check for the premium. Will it be income tax deductible to the business?"

   The premium is not deductible. Section 162, for lack of business purpose.

   Paying personal expenses with company checks can also expose the company to a piercing of the corporate veil of limited liability if there is no documentation as to why the business paid the personal expense.

   As in #2:
   - The IRS would include the premium in your gross income.
   - Absent documentation that the premium is part of your compensation, there would be no tax deduction for the business.
   - That would result in double taxation to you.
   - Give yourself a raise in pay for the premium, or if your business has pass through taxation, treat it as a capital distribution.

4. **Using a business check to pay premiums for a cross purchase buy/sell agreement**
   "My business partner[5] and I have a cross purchase buy/sell agreement.

   I am owner and beneficiary of a policy on his life, and he is owner and beneficiary of the policy on my life. If the business pays the premium, will it be deductible?"

   The premium is not deductible, even though it's business related. Because you and your partner own the policies personally the premiums would be treated as personal living expenses. Section 262 and Treasury Regulation Section 1.262-1(b)(1).

   You could also run in to the personal expense problem from #3.

   As in #2, absent a formal arrangement defining the premium as additional compensation, the premiums would be taxable to the respective policy owners, with no assurance of an offsetting compensation expense deduction for the business. Section 61 and Treas Reg Section 1.61-2(d)(2)(ii).

   Avoid the problem by treating the premiums as compensation or capital distributions to the respective policy owners.

5. **Using a business check to pay premiums for an entity/buy/sell agreement**
   "My business partner and I have an entity buy/sell agreement. If either of us die, the business has to buy back the decedent's ownership interest. We want the business to be owner and beneficiary of the policies on our lives. Will the premiums be deductible?"

   The premium is not deductible. Section 264(a)(1).

6. **Using personal funds to pay for a personal life insurance policy**
   "I need personal life insurance. Will the premium on my personal life insurance policy, the one on my life, that I own and pay with a personal check, be deductible?"

   The premium is not deductible. Sections 262, 264 and Treas Reg Section 1.262-1(b)(1).

7. **Key person indemnification for a key employee**
   "I have a key employee and my business would suffer financially if that person died. I'm going to insure that employee's life. My business will be owner and beneficiary of the life insurance policy. Will the premium be deductible?"

The premium is not deductible. Section 264(a)(1)

8. **Personal life insurance for a key employee**
"I have a key employee and I want to provide life insurance to that employee as an employee benefit, to give her a strong incentive to stay with my business. Will the premium be deductible?"

The premium is not deductible as a life insurance premium. Sections 264(a)(1) and 262, and Treas Reg 1-262-1(b)(1). However, if you treat it as additional compensation, the premiums will be deductible compensation expense to you and be taxable income to the employee, included in the employee's gross wages on the W-2, and subject to income tax withholding and payroll taxes.[6]

9. **Personal life insurance for a key employee with some back to the employer**

"To follow up on #8, what if the employee and I agree that the employee will name the business the beneficiary for part of the death benefit (for key person indemnification), and the business agrees to pay the proportionate part of the premium.[7] Will that make my share of the premium deductible?"

No, your share of the premium is not deductible. Section 264(a)(1)

Also, in the absence of a written, signed split dollar agreement, should the employee die, the IRS would want to tax your share of the death benefit to you as taxable income. Section 61(a). The taxable amount would be the death benefit paid to the business less premiums paid.

10. **Group term life insurance**
"I want to provide $50,000 of group term life insurance to each and every one of my employees. Will that be deductible to the business, and if so will it be taxable to them?"

Yes, that premium will be deductible as compensation expense, and the value of the coverage will not be taxable to the employees. However, the limit is $50,000 of coverage. Any coverage over $50,000 could be deductible by you as compensation expense and taxable to the covered employees. Sections 79 and 79(a)(1) and 162(a)(1).

11. **A tax election**
"I've heard that there is an election. If you deduct the premium on your tax return, you have to pay income tax on the death benefit. Is that true?"

There is no such election and there is no citation to the Internal Revenue Code to prove it. Even if the employer does incorrectly deduct the premium, the death benefit will be income tax free if it complies with Section 101. Pay careful attention to Section 101(j), relating to employer owned life insurance.

12. **Nonqualified Deferred Compensation Plans**
"I'm thinking of having our business sponsor a nonqualified deferred compensation plan for its senior management. I will informally fund the plan with life insurance. Will the premiums be deductible?"

The premium is not deductible. Section 264(a)(1)

If you and your co-owners participate in the plan, in retirement, after you have been bought out in accordance with the business's buy/sell agreement, the benefits you receive will be subject to income tax, effectively taxing you twice. Sections 264(a)(1) and 61(a)

Alternatively, you could take the money now, as compensation or a capital distribution, and put it in a personally owned heavily overfunded universal life insurance policy, the cash value of which you could tap in retirement to supplement your retirement income.[8]

13. **Qualified Deferred Compensation Plans**
"I would like my business to sponsor a qualified deferred compensation plan. If the plan buys life insurance on plan participants, will the premiums be deductible?"

Strictly speaking, no, the premium is not deductible. It is the *plan contribution* that is tax deductible. After the contribution has been determined and contributed, if the plan document allows life insurance and if the life insurance passes the incidental benefit tests, then qualified plan assets can be used to buy life insurance on a participant. Treas Reg 1.401-1(b)(1)(i) and (ii).

If a qualified plan buys life insurance on its participants there will be deemed a distribution equal to the value of the coverage. Because of that, if there is a death, part of the plan distribution will be treated as an income tax free death benefit.

Applicable code/treasury regulation sections

Section 61(a) says all income, from whatever source and in whatever form, is taxable unless specifically excluded.

Treasury Regulation Section 1.61-2(d), dealing with compensation paid other than in cash, says life insurance premiums paid by an employer on the life of an employee where the policy beneficiary is the employee's personal beneficiary are part of the gross income of the employee.

Please note that the regulation says the premiums are part of the employee's gross income; it does not say that they are deductible by the business as compensation expense. That is a separate and distinct step, to be proven by documentation.

Section 79 says the value of group term life insurance shall be included in an employee's income as compensation.

Section 79(a)(1), in a rare exception to the general rule, says only the coverage in excess of $50,000 is includable in the employee's income.

Section 101 deals with death benefit paid on life insurance policies. It says that generally, life insurance death benefits paid on personal life insurance policies are income tax free. One exception to that rule is that if a policy is transferred for value (e.g. sold, to a life settlement house for example) a portion of the death benefit will be subject to income tax.

Section 101(j) deals with life insurance owned by a business on the lives of employees and business owners. To preserve the income tax free nature of the life insurance death benefit, the business must comply with the requirements of 101(j)

Section 162 allows a business to deduct ordinary and necessary business expenses. In the absence of documentation for a particular expenditure explaining why it is an ordinary and necessary business expense, the expenditure can be disallowed.[9]

Section 162(a)(1) permits a deduction for reasonable compensation for personal services actually rendered. That would include regular compensation, plus compensation paid under Executive Bonus or Restrictive Executive Bonus arrangements, group term life insurance in excess of $50,000 plus any other compensation. So the money for a life insurance premium can be a deductible business expense, if it is characterized as compensation and included in the employee's gross wages.

Please note, treating the premium as compensation transfers taxation from the business (or business owner if the business has pass through taxation) to the employee.

Section 262 deals with personal, living and family expenses. It says that unless otherwise expressly provided for (i.e. as an itemized deductions), personal, living and family expenses are not deductible.

Treasury Regulation Section 1.262-1(b)(1) specifically includes life insurance premiums in the definition of personal, living and family expenses.

Section 264(a)(1) says a life insurance premium is not deductible if the taxpayer is either directly or indirectly the beneficiary. That would include life insurance purchased for key person indemnification, to informally fund a nonqualified deferred compensation plan, and to informally fund an entity (i.e. stock redemption) buy/sell agreements. The business is an indirect beneficiary simply by owning the policy.

Section 265(a)(1) says the expenses required to generate tax exempt income are not tax deductible.

Treasury Regulation Section 1.401-1(b)(1)(i) and (ii) contain the tests that determine whether or not the death benefits are incidental to the main purpose of providing plan participants with retirement income.

Documentation

As pointed out in case studies 2-4, inclusion of the premium in your, or an employee's gross income, is no guarantee that the business will get an offsetting compensation expense deduction. The arrangement needs to be documented in writing and signed by the parties affected. Legal counsel should be consulted to determine what documentation is adequate to validate the arrangement.

Please note — in disagreements (i.e. audits of income tax returns) with the IRS, generally the burden of proof rests on the taxpayer. In the absence of documentation, the IRS will take the position that generates the most tax revenue.

Generally accepted accounting principles

Generally accepted accounting principles (GAAP) accept that life insurance can be a valid business expense, deductible on the business's financial statements. Conversely, GAAP includes death benefits in a business's revenue.

For accounting purposes, when reporting on permanent life insurance, only the premium in excess of each year's increase in cash surrender value is financial statement life insurance expense. It is possible, even likely for appropriately funded cash value life insurance policies, that eventually each year's increase in cash surrender value will exceed the premium. This increase turns the policy into an income producing asset. That income will be earned, tax deferred, inside the policy.

Business owned life insurance is typically reported on the business's balance sheet as a nonoperating "Other Asset", at its cash surrender value.

Conclusion

Business owners often inquire regardling the tax deductibility of their premiums. They feel that if the business owns the policy, somehow the premium should be deductible. As we have seen, in the end, it is not. Yes, the business can deduct it as compensation, but on the employee's tax return, it is not deductible, so taxation has simply been transferred. As previously stated, Congress generally gives us an income tax free death benefit. We have now seen, in detail, that with the notable exception of the $50,000 of group term life insurance, we don't get an income tax deduction for the premium as well.

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[1] Life insurance owned by a business must comply with the provisions of Section 101(j) IRC. Consult tax counsel for guidance. See also Nationwide Insurance, NFM-4596AO.4 - *The effects of the Pension Protection Act of 2006*

[2] Womrath, Inc. v. Comr., 22 B.T.A. 335 (1931)

[3] All compensation must be reasonable in light of services actually performed. Section 162(a)(1) IRC

[4] If the premium is treated as additional compensation it will be included in your gross wages on your W-2. If it's treated as a capital distribution it will show up on your Schedule K-1.

[5] Partner is used in the generic sense to describe co-owners; they could be partners in a partnership, co-members in a limited liability company, or co-shareholders in a corporation.

[6] Nationwide Insurance NFM-1848AO.11 - *What's the blueprint for keeping good employees?* Reporting the income on a 1099 is not acceptable; the person is an employee who receives a wage, and wages are subject to income tax withholding and payroll taxes.

[7] The premium payable would be based on annual renewable term insurance rates. It would be nondeductible life insurance expense to the business and taxable income to the employee. Section 264(a)(1) and 61(a) IRC. Such an arrangement needs to be documented in a formal, written split dollar agreement, to protect the income tax free nature of the death benefit to the employer.

[8] Nationwide Insurance NFM-1846AO.10 - *What will your retirement look like?*

[9] Womrath, Inc. v. Comr., 22 B.T.A. 335 (1931)

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