

## Transferring Business/Employer Owned Life Insurance

Life insurance is a versatile tool that can be leveraged by a business for a variety of purposes, including funding executive benefits, buy-sell arrangements, and protecting against the loss of a key employee. Because of this versatility, it's common for employers to own life insurance policies covering the lives of select employees, including ones who are also owners in the business. But what happens when a policy no longer serves its business purpose? Here are some common scenarios:

- A sales manager retires while the business still holds a policy it bought to compensate for lost sales revenue in the event of the manager's premature death. The business considers its options.
- A business bought a policy on its owner in its early years to shore up its creditworthiness. The owner is now selling the company and would like to keep the policy for her personal planning needs.
- A company bought policies on its two owners to fund an entity buyout arrangement in the event of death. The two owners are now selling the business, and the coverage is no longer needed.

No matter the reason for wanting to transfer policy ownership from an employer to an insured, there are a number of considerations. The following scenarios can help illustrate some of them.

### Scenario 1: Key Employee Leaves the Business

ABC is an S-Corporation and owns a life insurance policy on its top sales manager Maria. Maria has decided to leave ABC and join another company.

What are ABC's options regarding the policy?

1. It could keep the policy until Maria passes away.
2. It could surrender the policy for its cash value.
3. It could change policy ownership to Maria as a gesture of goodwill should she ever want to return.

ABC reviews the costs and benefits of each option and decides to change the policy ownership to Maria. However, it must account for the tax consequences of the decision. How is this done?

First, ABC needs to determine the value of the policy. The value of a policy for tax purposes is its fair market value at the time of transfer. Factors that determine fair market value include the general health of the insured, the policy's reserves, and its cash value or unearned premium. The policy's issuing company can provide some guidance on value.

ABC also determines that distribution of the policy to Maria is employee compensation. As a result, Maria may receive a tax form (e.g., W-2) from ABC after she has left employment. ABC also determines the distribution of the policy to Maria may be tax deductible on its annual tax return to the extent the transfer is reasonable compensation.

## Scenario 2: Business Owner is Selling

Gisele started her market consulting firm, PDQ LLC, in 2001. In 2003 she bought a term policy on her own life in PDQ's name and four years later converted it to a permanent contract. She recently received an offer from a buyer to purchase PDQ's operations and client base and decided to accept but wants to keep the policy on her life for its tax-advantaged cash value build-up.

In this scenario, since Gisele is the business owner, a key consideration in addition to valuing the policy is to know how the company is structured, as this determines whether the transfer of ownership is a form of compensation, a dividend, or a distribution of capital.

As a single member LLC, PDQ is taxed as a pass-through entity, meaning all its net earnings are taxed personally to Gisele, and the adjusted value of all its undistributed cash and property (its "capital") forms her tax basis in the business. By taking the policy out of the business, Gisele makes a distribution of capital to herself, reducing her tax basis in PDQ. Though she is not taxed directly on the capital distribution, when her new buyer completes the purchase of PDQ, her tax basis in the business will have been reduced by the value of the policy that was distributed, increasing her capital gain on the sale.

## Scenario 3: A Buy/Sell Agreement is No Longer Needed

XYZ is a C corporation with two owners, A and B. Each owns 50% of the business. XYZ has an entity buy-sell agreement and owns life insurance policies on A and B to fund it. The owners have decided to sell the business and would like take ownership of the policies for themselves.

Unlike an LLC, as a C corporation, XYZ's earnings are not taxed personally to A and B. Rather, distributions to A and B are treated either as compensation or a dividend. A dividend, generally, is a cash distribution of the corporation's net annual profit. In this case, since the policies on A's and B's lives are not from its net annual profit, the change of policy ownership will be treated as compensation. As in Scenario 1, A and B will receive a tax form from XYZ reporting the policies' fair market value as compensation to them, and XYZ will be eligible to deduct the same amount of compensation as an expense on its corporate tax return.

## General Overview of Common Tax Questions

As you can see, certain tax issues arise when transferring a life insurance policy to or from a business. For the most part, life insurance is treated like other appreciated property. Key factors include: the fair market value of the property, the owner's cost basis, and whether the transfer triggers tax recognition. In addition, when transferring life insurance policies an analysis of the transfer for value rules of Internal Revenue Code Section 101 should be made. The following is some general tax information:

- Distributions of Appreciated Property (like life insurance) for **C-Corporations**:
  - How is the Business taxed?
    - Gain (calculated as Fair Market Value – Basis) may be taxable to business as a constructive sale of property.
    - Property distributed as compensation is deductible, if reasonable. Property distributed as a dividend is nondeductible to the corporation.
  - How is the Employee taxed?
    - Taxable amount is property's fair market value (FMV).
    - If dividend, taxable at 0%, 15%, or 20% (currently).

- If compensation, taxed as ordinary income at the employee’s marginal rate.
- Distributions of Appreciated Property for **S-Corporations**:
  - How is the business taxed?
    - Gain (calculated as Fair Market Value – Basis) is taxable to shareholders.
    - Property distributed as compensation is deductible, if reasonable.
  - How is the employee taxed?
    - Compensation – ordinary income taxable at employee’s marginal rate.
    - Capital Gain distributions in excess of shareholder basis are capital gain.
- Distributions of Appreciated Property for **Partnership/LLC**:
  - How is the business taxed?
    - Gain is generally not recognized on distribution; it is recognized at the time of sale by receiving partner.
  - How is the employee taxed?
    - Gain generally not recognized on distribution; it is recognized at the time of sale by receiving partner.
    - Partner’s basis is reduced by distribution; distributions in excess of partner’s basis are capital gain.

### **Prudential is Here to Support You**

Business owned life insurance policies, like all life insurance policies, should be reviewed on a routine basis as you connect with your business owner clients to discuss their plans. When a life insurance policy no longer meets a business’ need, it’s an opportunity to consider the options available and the potential tax consequences to help achieve a desired outcome.

As you work with business owner clients, Prudential’s Advanced Planning team is available to help answer questions and design cases for their individual circumstances. For questions regarding considerations for transferring employer owned life insurance, small business solutions or any advanced concept or strategy, please contact Advanced Planning at 800-800-2738, option 4.

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