

# Guidance on S Corporation Life Insurance Premiums Raises Questions

By: **Kevin J. Walsh, CPA, CVA**

**T**he IRS recently issued long-awaited guidance on the treatment of life insurance premiums paid and life insurance proceeds received by an S corporation. In Rev. Rul. 2008-42, issued July 1, 2008, the Service ruled that insurance premiums paid by an S corporation on an employer-owned life insurance contract on an employee of which the corporation is the beneficiary do not reduce the corporation's accumulated adjustments account (AAA). The IRS further ruled that the receipt of tax-exempt life insurance proceeds by an S corporation does not increase AAA.

The fact pattern provided in the ruling was that of an S corporation with accumulated earnings and profits (AE&P) that purchased and paid premiums for a life insurance policy on the life of a key employee.

The rationale provided for the position taken in the ruling is that life insurance proceeds that are tax free under Sec. 101 constitute tax-exempt income as described in Regs. Sec. 1.1366-1(a)(2)(viii). This status as tax-exempt income removes the life insurance from AAA under the exclusion from AAA of tax-exempt income and related expenses (Sec. 1368(e)(1)(A)). Life insurance premiums paid on tax-exempt policies are considered to fall into the "related expenses" category and are thus excluded from AAA as well.

It is obvious that the IRS intended to make it clear in this ruling that distributions

of life insurance proceeds generally could not be made on a tax-free basis as long as an S corporation has AE&P. While the ruling was clear on this point, what it did not say was a bit disappointing.

This ruling is, in essence, a negative instruction. It does not say what to do with insurance premiums and life insurance proceeds. It merely says that premiums paid on tax-exempt policies do not reduce AAA and that life insurance proceeds do not increase AAA. As a consequence, technical issues related to the effect on AAA of other policy types, including policies with a cash surrender value or split-dollar policies, remain unaddressed.

The ruling does not provide guidance on what account should reflect the premiums paid or proceeds received if they are not reflected in AAA. The only logical place to put the premiums and proceeds is in the other adjustments account (OAA). This OAA, not described in the Code or regulations but listed on Form 1120S, U.S. Income Tax Return for an S Corporation, Schedule M-2, and instructions, is "adjusted for tax-exempt income (and related expenses)" per the instructions to that form. It seems odd that the ruling did not indicate that the premiums and proceeds would go into this account, especially given that instructions and forms are not authoritative.

Further, the ruling did not state, although the implication is clear, that

taxable life insurance policy proceeds will affect AAA. Policies taxable under Sec. 101(j) or under the transfer-for-value rules of Sec. 101(a)(2) will increase AAA, to the extent of the taxable portion of the proceeds received. It is not clear from the ruling how an S corporation should handle premiums paid on these policies. Hopefully, future guidance will provide insight into how to handle different types of policy premiums and proceeds as well as instruction on the use of the OAA.

## What Now?

The ruling does not have a prospective effective date. The language seems to indicate that the prescribed treatment of tax-exempt life insurance proceeds and related premium expenses is the way S corporations should have always handled these items. Due to the lack of prior guidance, some commentators have previously suggested that an S corporation should reduce AAA for the payment of life insurance premiums.

As a consequence, all S corporations paying for life insurance should review prior treatment of the premium payments and the receipt of insurance proceeds. If the life insurance premiums paid in the past erroneously reduced AAA, it would appear to be appropriate to move the cumulative premium amount from AAA to OAA. This will increase AAA and thus

provide a larger cushion for distribution of the previously taxed income in AAA. In addition, if the receipt of proceeds increased AAA, it would be appropriate to move the proceeds to the OAA.

An S corporation with AE&P that has made a distribution in excess of AAA in an open year has an additional incentive to review the tax treatment of life insurance premiums in all prior years. If the S corporation mistakenly reduced AAA in the past, it could file amended returns to reflect an increase in AAA due to the removal of the life insurance premiums and an equal reduction in the amount of the taxable distribution considered to be from AE&P.

Practitioners should note that this ruling does not affect shareholder basis directly. Tax-exempt income and expense affect the shareholder's basis each year regardless of the treatment at the corporate level. The impact at the shareholder level occurs only when an S corporation with AE&P makes distributions in excess of AAA. A distribution from AE&P does not reduce basis because it is a separately taxable event.

### Conclusion

Rev. Rul. 2008-42 provides some clarity to a recurring issue but also leaves many questions unanswered. Hopefully, the Service will consider offering additional guidance in this area to resolve the remaining

issues. In the meantime, S corporations should review the handling of life insurance premiums to make sure their treatment complies with the IRS's position as stated in this ruling.

TTA

### EditorNotes

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## IRS Announces Disaster Relief for Hurricane Victims

By James Beavers, J.D., LL.M., CPA

The IRS has announced tax relief under Sec. 7508A for Louisiana and Texas taxpayers who were affected by Hurricanes Gustav and Ike. The relief applies to taxpayers who live in or have a principal place of business in Texas counties or Louisiana parishes that were declared presidential disaster areas as a result of the storms (IR-2008-100, IR-2008-107, IR-2008-108).

For Hurricane Gustav victims, the relief applies to return filing, tax payment, and other time-sensitive acts otherwise due between September 1, 2008, and January 5, 2009. For victims of Hurricane Ike, the relief applies to acts due on or after September 7 (for affected Texas taxpayers) or September 11 (for affected Louisiana taxpayers) and before January 5, 2009. This includes individual estimated tax returns and corporate tax returns due on September 15, 2008, and extended individual returns due on October 15, 2008.

The relief includes an extension of time until January 5, 2009, for affected taxpayers to file most tax returns (including individual, corporate, and estate and trust income tax returns; partnership and S corporation returns; estate, gift, and generation-skipping transfer tax returns; and employment and certain excise tax returns) or to make tax payments, including estimated tax payments, that have either an original or an extended due date occurring on or after the dates specified above for the particular hurricane and location and before January 5, 2009. The relief also includes an extension of time to perform certain time-sensitive acts described in Rev. Proc. 2007-56.

Affected taxpayers who receive a penalty notice from the IRS should call the telephone number on the notice to have the Service abate any interest and any late filing or late payment penalties that would otherwise apply. Penalties or interest will be abated only for taxpayers who have an original or extended filing or payment due date between September 1, 2008, and January 5, 2009.

While the primary beneficiaries of the tax relief are taxpayers who live and have businesses in the disaster areas, relief is also available to taxpayers not in the covered disaster areas but whose books, records, or tax professionals' offices are in the covered disaster areas. All relief workers affiliated with a recognized government or philanthropic organization assisting in the relief activities in the covered disaster areas are also covered.

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