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Q 56. When an S corporation pays the premium on a life insurance policy insuring a shareholder or employee, what are the tax consequences?

Generally, an S corporation does not pay taxes; instead, items of income, deduction, loss and credit are passed through to the shareholders who report their pro rata shares on their individual returns. Payment of premiums by an S corporation should be characterized as a nondeductible expense, as deductible compensation, or as a nondeductible distribution of profits under the same general rules applicable to regular (C) corporations (see [Q 48](#) to [Q 54](#)). However, the resulting tax treatment of the shareholders would, in some instances, differ.

Where the payment is a nondeductible expense, as it would be if the corporation were both owner and beneficiary of a key person policy, each shareholder reduces his basis in his shares by his proportionate part of the nondeductible expense.^[1]

If the particular premium payments are considered compensation (for example, the employee owns the policy or has a beneficial interest in it – see [Q 53](#) to [Q 54](#)), the amount of compensation would be deductible in determining the corporation's income or loss which is reported pro rata by each shareholder. The amount of the compensation would then be included in income by the insured employee.^[2]

If the premium payment is considered a distribution with respect to stock to an individual shareholder ([Q 53](#), [Q 54](#)) the tax treatment would depend on whether or not the corporation has accumulated earnings and profits. If the corporation has no accumulated earnings and profits, the payment is treated first as a return of investment and then as capital gain. If the corporation has accumulated earnings and profits, part of the distribution might be treated as a dividend.^[3] An S corporation may have accumulated earnings and profits from years when it was a C corporation or as the result of a corporate acquisition. How S corporation distributions are taxed is explained in [Q 839](#).

In a revenue ruling issued in 2008, the Service outlined the effects of premiums paid by an S corporation on an employer-owned life insurance (EOLI) contract and the benefits received by reason of death of the insured on its accumulated adjustments account (AAA) under IRC Section 1368. The Service ruled that: (1) premiums paid by an S corporation on an EOLI contract, of which the S corporation is directly or indirectly a beneficiary, do not reduce the S corporation's AAA; (2) the benefits received by reason of the death of the insured from an EOLI contract that meets an exception under IRC Section 101(j)(2) do not increase the S corporation's AAA.^[4]

[\[1\]](#)
IRC Sec. 1367(a)(2)(D).

[\[2\]](#)
IRC Secs. 1363, 1366.

[\[3\]](#)
IRC Sec. 1368.

[\[4\]](#)
Rev. Rul. 2008-42, 2008-30 IRB 175.