StatonWalsh

Financial Clarity Through Transparency

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Life Insurance in the Business World

Life insurance plays a number of important roles in the business world, benefiting business owners, employees, and family members.

Business Continuation

The loss of a business owner or a key employee can seriously damage a small business or even result in the business closing its doors. Advance planning can help cushion the impact of such events.

- **Death of a business owner:** If a business owner dies, a buy-sell agreement can provide a smooth transition of total ownership and control to those who will keep the business going. For a corporation, a stock-redemption agreement may be used to ease the transfer of the deceased owner's shares to the surviving shareholders. Life insurance is frequently used to fund these types of agreements.[1]
- **Key-employee insurance:** Life insurance on the life of a key employee helps to cover the costs of finding and training a replacement, as well as meeting any monetary obligations to the deceased employee's survivors.[1]

Retirement Planning

There are many ways in which life insurance is used in accumulating funds for retirement:

- **Fully-insured defined benefit retirement plan:** IRC Sec. 412(e)(3)[2] allows for the use of annuities and/or life insurance policies to fund retirement.
- **Life insurance inside qualified retirement plans:** Federal income tax law allows defined benefit retirement plans and certain types of defined contribution retirement plans to allocate a portion of the funds contributed each year to life insurance as a retirement funding vehicle.
- **Nonqualified deferred compensation:** These arrangements allow selected employees (the employer can pick and choose) to defer receipt of a portion of their compensation until a later date. These plans do not meet federal income tax requirements to be considered "qualified" plans. Life insurance can be used to informally fund such arrangements.

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[1] Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local income tax law may vary.
[2] Previously, IRC Sec. 412(i).

Estate and Survivor Financial Needs Planning

Life insurance also plays a significant role in estate and survivor needs planning:

- **Group term life insurance:** Group term life insurance can be provided to the employees of a business, with premiums generally much lower than individual term life policies. Generally, the first $50,000 of such coverage is tax-free to the employee.
- **Executive life insurance:** An employer can help fund employee-owned, individual life insurance policies for selected executives or key employees through either a "bonus" plan under IRC Sec. 162, or as a part of collateral assignment split-dollar arrangement.[1]
- **Death benefit only plan:** A Death Benefit Only (DBO) plan is a form of deferred compensation plan. In a DBO plan an employee defers a portion of his or her compensation. No benefits are payable during the employee's lifetime. At the employee's death, the deferred compensation is paid to the employee's named beneficiary, with the entire benefit being taxed as ordinary income.

Seek Professional Guidance

Correctly used, life insurance is a highly useful tool in the business world. However, careful attention must be paid to federal, state, and local law to ensure that all legal requirements are met. The guidance of knowledgeable legal, tax, employee benefit, and life insurance professionals is strongly recommended.

[1] "Split-dollar" arrangements are a way of paying for life insurance. In the business context, generally, an employer and an employee will agree to split the premiums and benefits of a life insurance policy.

Employer-Owned Life Insurance

There are many situations in the business world where employer ownership of a life insurance contract on the life of an employee plays a vital role in the financial life of the business. For example, employer-owned life insurance (EOLI) can help defray the often high costs involved in recruiting and training an individual to replace a "key" employee. EOLI contracts are also commonly used as a funding source for buy-sell agreements and non-qualified deferred compensation arrangements.

Generally, under federal income tax law,[1] the proceeds of a life insurance contract payable because of the death of the insured are excluded from income. However, under IRC Sec. 101(j) the proceeds of an EOLI contract are generally excluded from income only to the extent of the premiums and other amounts paid by the policyholder for the contract. Any "excess" death benefit above this amount is included in gross income.

IRC Sec. 101(j) also contains a series of rules which, if followed carefully, allow the total death benefit of an EOLI life insurance contract to be received income-tax free.

Key Definitions

- **Employer-owned life insurance contract:** A life insurance contract that is (1) owned by a person engaged in a trade or business and under which such person (or a related person) is directly or indirectly a beneficiary under the contract, and (2) which covers the life of an insured who is an employee of the "applicable policyholder" on the date the contract is issued.

- **Applicable policyholder:** Generally, the person who owns the contract. The term also includes any person who bears a relationship to the owner specified in IRC Sec. 267(b) or IRC Sec. 707(b)(1), or who is engaged in trades or businesses with the owner which are under "common control" within the meaning of IRC Sec. 52(a) or (b).

- **Insured:** An individual covered by the contract who is a U.S. citizen or resident. If the contract covers the joint lives of two individuals, the term "insured" includes both.
- **Employee:** In addition to the common law definition, the term "employee" includes an officer, director, and highly compensated employee (as defined in IRC Sec. 414(q)).

[1] The discussion here concerns federal income tax law. State or local law may vary.

Notice and Consent

Before the EOLI contract is issued, specific "Notice and Consent" requirements must be met:

- The employee must be notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract is issued.
- The employee must provide written consent to being insured under the contract and that the coverage may continue after the insured terminates employment.
- The employee must be informed in writing that the applicable policyholder will be the beneficiary of any proceeds payable upon the death of the employee.

Exceptions

Assuming that all of the "Notice and Consent" requirements have first been met, the proceeds from an EOLI contract paid because of the death of an employee will be received income-tax free if any of the following exceptions applies:

- **Recent employment:** If the insured was an employee any time during the 12-month period before death.

- **Executives:** If, at the time the policy was *issued*, the insured was a director, or a highly compensated employee, as defined under the rules relating to qualified retirement plans, determined without regard to the election regarding the top-paid 20 percent of employees, or a highly compensated individual, as defined under the rules relating to self-insured medical reimbursement plans, determined by substituting the highest-paid 35% of employees for the highest-paid 25% of employees.

- **Amounts paid to the insured's heirs:** Death proceeds are excluded from income to the extent that an amount is (1) paid to a family member[1] of the insured, to an individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), to a trust established for the benefit of any such family member or designated beneficiary, or to the estate of the insured; or (2) is used to purchase an equity (or partnership capital or profits) interest in the applicable policyholder from such a family member, beneficiary, trust, or estate.

[1] A family member, as defined in IRC Sec. 267(c)(4) includes the individual's brothers and sisters, spouse, ancestors, and lineal descendants.

Transition Rule and IRC Sec.1035 Exchanges

IRC Sec. 101(j) generally applies to EOLI contracts issued after August 17, 2006. There is an exception for policies issued after that date which were acquired in an IRC Sec. 1035 exchange for a contract issued on or before that date. Any material change in the death benefit or other material change can result in the contract being treated as a new contract, and thus subject to IRC Sec. 101(j).[1]

Annual Reporting Requirement

IRC Sec. 6039I imposes both record keeping and annual reporting requirements on any employer that owns one or more EOLI contracts. IRS Form 8925 is used to make the required annual report.

Seek Professional Guidance

Given the complexities involved, and because the dollar cost of not meeting the requirements of IRC Sec. 101(j) can be high, competent professional guidance is strongly recommended.

[1] See IRS Notice 2009-48, Q&A14, for a description of changes to existing EOLI contracts which would not be considered "material" changes.

Executive Carve-Out Plan

An Alternative to Group Term Life Insurance

Executive Carve Out Defined

An executive "carve-out" plan is a plan which provides life insurance coverage on selected employees, by carving out all or a portion of their coverage under an employer-sponsored group term plan, and also provides them with individual policies.

Primary Objective

- To provide additional benefits to the employee in the form of accumulated cash values and post retirement coverage.

Plan Design

The plan may be designed either as:

- A bonus plan [IRC Sec. 162(a)], or
- A collateral-assignment split-dollar arrangement, taxed under the loan regime.

Advantages	IRC Sec. 162 Bonus Plans	Split-Dollar Loan Regime
Employer cost tax deductible	Yes	No
Employer cost recoverable	No	Yes
Cash value available to employee	Yes	Maybe[1]
Post retirement benefits	Yes	Yes
Employer discretion for coverage	Yes	Yes

[1] Subject to collateral assignment.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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