

# Taking Cash Out: Life Insurance

## *How to Help Business Owners Buy Affordable Life Insurance*

Terry Myers, JD and Dee DeScherer, JD

### **More Choices**

Company owners may have set up a buy-sell agreement funded by life insurance. But suppose the owners want to provide additional life insurance protection for their families? There are various arrangements that can be used by a company to help its owners cope with the cost of additional life insurance. We have outlined these arrangements below.

### **Term Insurance**

As a general rule, the cost of employer-paid life insurance is taxable to employees when the employees have the rights normally associated with life insurance ownership, such as the right to name the beneficiary (e.g., Lee, U.S.D.C. [S.C., 1963]). However, the tax code provides a limited exclusion for employer-paid group term insurance. The cost of group-term coverage is taxable only to the extent it exceeds the sum of (1) the cost of \$50,000 of coverage and (2) any amount paid by the employee toward the purchase of the insurance [IRC Sec. 79]. The taxable cost of coverage in excess of the excludable amount is determined using Table I of Reg. §1.79-3(d)(2).

The exclusion is available to owners and other "key employees" only if the plan is nondiscriminatory. A plan won't meet the nondiscrimination requirement unless all benefits available to key employee participants are also available to all other participants [IRC Sec. 79(d)(4)]. But a plan won't fail to meet this requirements merely because the amount of life insurance provided to employees under the plan bears a uniform relationship to the total compensation or the basic or regular rate of compensation of the employees [IRC Sec. 79(d)(5)].

**Example:** XYZ Inc. provides each employee with \$1,000 of term life coverage for every \$1,000 of compensation. XYZ's owner receives \$150,000 of compensation and \$150,000 of term life coverage. All other employees receive \$25,000 of compensation and \$25,000 of coverage. The plan is not considered discriminatory and the first \$50,000 of coverage provided to the owner is excludable.

### **Executive Bonus Plan**

Owner-employees who are interested in whole life insurance coverage may want to consider an executive bonus plan (also known as a Section 162 plan). There is no nondiscrimination requirement, so the plan can cover only the owner-employee. The owner-employee takes out the policy, but the company pays the premiums.

The premium payments are treated as additional taxable wages to the owner-employee. The premium payments are deductible by the company under IRC Sec, 162 as long as (1) the company is not a direct or indirect beneficiary under the policy and (2) the owner-employee's total compensation (including the premiums) is reasonable for the personal services actually rendered. The deduction won't be disallowed merely because the company derives a benefit from the increased efficiency of the owner-employee [Reg. 1.264-(1)(b)].

A Section 162 plan is sometimes used in conjunction with a nondiscriminatory group term insurance plan in order to provide additional coverage to the owner (and other selected employees). An executive bonus plan may also be set up as a "double bonus" plan, in which case the company also pays the income tax owed by the owner-employee.

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### **Death-Benefit-Only Plan**

Under this arrangement (also known as a "survivor income benefit" plan), a company agrees to provide benefits to an owner-employee's designated beneficiaries if he or she dies prior to retirement. The company typically purchases a life insurance policy on the owner-employee's life to provide an informal funding vehicle for the company's obligations under the agreement.

Because the company is the beneficiary of the policy, the premium payments are not deductible [IRC Sec. 264(a)(1)]. However, the proceeds received by the company on the owner-employee's death are tax-free [IRC Sec. 101(a)(1)].

The amounts paid out by the company under its agreement with the owner-employee are deductible by the company. Because the payments arise out of the company's employment relationship with the owner-employee, they are taxable to his or her beneficiaries as income in respect to a decedent under IRC Sec. 691 [Rev. Rul. 73-327].

If the owner-employee survives to retirement, the company can use the life insurance policy to pay retirement benefits to the owner-employee.

### **Split-Dollar Life Insurance**

Under a split-dollar life insurance arrangement, a company and the owner-employee agree to divide up the benefits and, in some cases, the costs of a life insurance contract. For example, under the traditional split-dollar arrangement, the company may pay that portion of the annual premium equal to the increase in the policy's cash value for the year, while the owner-employee pays the remaining portion.

Split-dollar arrangements are generally set up in one of two basic ways. Under the endorsement method, the company is the owner of the policy, but the owner-employee has the right to name the beneficiary for the risk portion of the death benefit. At the owner-employee's death, the company receives that portion of the death benefit equal to the greater of the total premiums paid or the policy's cash value. The owner-employee's designated beneficiary receives the remaining risk portion of the death benefit.

Under the collateral assignment method, the owner-employee is the policy owner, but he or she assigns the policy to the company as security for the employer's premium advances. The company's share of the death benefits equals its premium payments and the owner-employee's beneficiary receives the balance. "Equity" split-dollar insurance is a variation on the traditional split-dollar insurance. With equity split-dollar, the death benefit going to the owner-employee's beneficiaries is not limited to what's left over after the company gets the cash value; the beneficiaries receive a portion of the cash value as well. The company generally recovers only its costs—an amount equal to the cumulative premiums—out of the death benefit. The remainder is paid to the beneficiaries. During the life of the policy, when the cash-value buildup exceeds the cumulative premiums, the owner-employee is considered to have an "equity" interest in the policy. If the policy is surrendered, the employee receives a portion of the cash value.

In 2003, the IRS finalized new regulations governing the tax treatment of split-dollar insurance policies. The regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003.

Under the new regulations, the tax treatment of split-dollar insurance depends on whether or not a policy is an equity split-dollar policy.

**Non-equity Split Dollar.** Policies in which an owner-employee has no equity interest, such as traditional split-dollar insurance, are taxed under an "economic benefit" regime. The company is treated as providing economic benefits to the owner-employee and those economic benefits must be accounted for fully and consistently by both parties. The owner-employee must report the value of the economic benefits as compensation on his or her return for the year in which the benefits are provided. The company must take the economic benefits into account by reporting them on the appropriate employment tax and information returns.

The value of the economic benefit equals the value of the current life insurance protection (death benefit less cash value). The value of current life insurance protection is set out in Table 2001 issued by the IRS [Notice 2001-10]. The IRS regulations provide that, subject to an anti-abuse rule, current life insurance protection is determined on the last day of the owner-employee's tax year unless the parties agree to use the policy anniversary date.

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**Equity Split Dollar.** Equity split-dollar arrangements between a company and an owner-employee are taxed under one of two mutually exclusive regime-the "economic benefit" regime or a "loan" regime. The economic benefit regime applies to employer-owned (endorsement method) policies and the loan regime applies to employee-owned (collateral assignment method) policies.

In the case of equity split-dollar policies subject to the economic benefit regime, the value of the economic benefits provided to the owner-employee equals not only the cost of any current life insurance protection provided to the company, but also the amount of policy cash value to which the owner-employee has "current access" (to the extent that such amount was not actually taken into account for a prior taxable year).

Under the IRS regulations, an owner-employee has current access to any portion of the policy cash value that is directly or indirectly accessible by the owner-employee, or inaccessible to the company. An owner-employee has "access" to policy cash value if he or she can directly or indirectly make a withdrawal from the policy, borrow from the policy, or effect a total or partial surrender of the policy. The policy cash value, like the amount of current life insurance protection, is determined as of the last day of the owner-employee's tax year unless the parties agree to use the policy anniversary date.

For split-dollar policies subject to the loan regime, the owner-employee and the company are generally treated, respectively, as borrower and lender for all premium payments made by the company.

If the "loan" to the owner-employee does not provide for sufficient interest, the loan is subject to the rules for "below-market" loans [IRC Sec. 7872]. If a split-dollar loan is a below-market loan, then, in general, the loan is recharacterized as a loan with interest at the applicable Federal rate (AFR), coupled with an imputed transfer of compensation by the company to the owner-employee.

- The IRS regulations make employer-owned equity split-dollar policies unattractive-particularly, in the case of mature policies when the owner-employee has substantial increases annually in his or her equity interest. Employee-owned equity policies are more appealing by comparison as long as interest rates remain relatively low. The imputed compensation amount is not that significant.

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